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TAX FOUNDATION'S *50th Anniversary Year* VOL. 31, NO. 7 NOVEMBER/DECEMBER 1987

# TAX·FEATURES

## Tax Foundation Marks 50th Anniversary; Honors Senator Moynihan for Public Service

### *Shadow Budget Committee Report Card Gives Congress and Administration Failing Marks for Fiscal Year 1987*

By grading Congress and the Administration on five different aspects of budgetary performance, the Shadow Committee on the Federal Budget has handed down a report card that would make any self-respecting student cringe: A– for economic conditions (a judgment handed out prior to Wall Street's October 19 Black Monday); F for policy leadership; F for truth in budgeting; F for completion of required budget tasks; and for deficit reduction: a B for appearance, but a D for substance.

As bad as these grades are, they simply reflect the numerous budgetary failures and comparatively few successes that marked fiscal 1987.

The economy has not grown at the rate assumed in the budget, but it continues to demonstrate remarkable vigor, the report notes. The budget deficit was about $60 billion below the previous year's level, but much of the improvement was due to one-time factors that will not be available in future fiscal years. Congress changed the way the budget accounts for asset sales and other transactions that lower the deficit without producing real savings, but only after using billions of dollars of these tricks in the 1987 budget. Finally, Congress failed to enact a single regular appropriation bill by the start of the 1988 fiscal year, but its work was impeded by a recalcitrant President who refused to enter into negotiations with the Legislative Branch.

Even the one area of good performance is qualified by a "but". Good news about the deficit has been acccompanied by a sharp run-up in interest rates, possibly because investors fear that deficit reduction will be short-lived. If the big drop in 1987 proves to be just a blip in the upward trend of the deficit, the nation will pay a heavy price for the failure of the President and Congress to provide the leadership that would produce enduring deficit reduction.

Daniel Patrick Moynihan, senior United States Senator from New York State, will receive the Tax Foundation's Distinguished Public Service Award for 1987 at the Foundation's 50th Anniversary Dinner December 2. The Dinner concludes the Foundation's day-long conference on "Tax and Fiscal Policy — The New Agenda" at the Waldorf-Astoria hotel in New York City.

Hans W. Wanders, President of The Wachovia Corporation and Chairman of the Foundation's Board of Trustees, will present the award. A major policy address by Senator Moynihan will follow his acceptance.

Daniel Patrick Moynihan was elected to the United States Senate on November 2, 1976 and reelected in November 1982. The Senator serves on the Finance and the Environment and Public Works Committees and on the Select Committee on Intelligence; he is Chairman of the Subcommittee on Public Assistance of the Finance Committee.

Senator Moynihan has held Cabinet or Subcabinet posts under Presidents Kennedy, Johnson, Nixon, and Ford. He has served as United States Ambassador to India and as U.S. Permanent Representative to the United Nations. He has also held high administrative positions in New York State. His career in education includes posts at MIT and Harvard.

### National Conference

The morning sessions of the all-day program will focus on the economic outlook and the Federal Budget and will include presentations by Edgar R. Fiedler of the Conference Board, White House Senior Policy Analyst Bruce Bartlett, Harvey Galper of Peat Marwick Main & Co. and Allen Schick of the University of Maryland.

Jeffrey H. Birnbaum, Congressional Reporter for The Wall Street Journal and Coauthor of *Showdown at Gucci Gulch,* will keynote the conference luncheon.

The afternoon session will address "Tax Policy Post Reform," with presentations by J. Roger Mentz of Cadwalader, Wickersham & Taft and former Assistant Secretary of the Treasury of Tax Policy, and David H. Brockway, Chief of Staff of the Joint Committee on Taxation.

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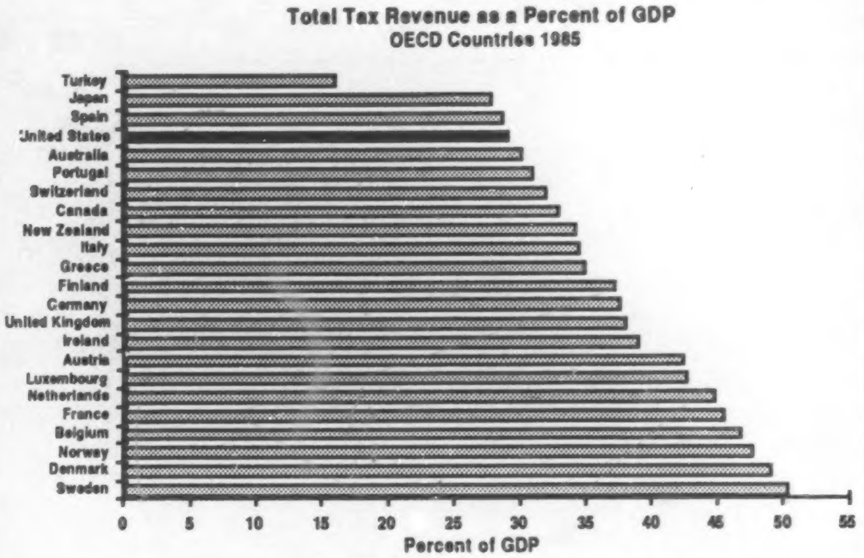
# OECD Nations Show Great Diversity in Approach to Taxation



Despite numerous economic and political ties, member nations of the Organization for Economic Cooperation and Development (OECD) display great disparity in how they structure their respective tax systems.

In 1985 (latest reported), the share of revenue raised by individual and corporate income taxes ranged from less than 18 percent in France and Greece to 69 percent in New Zealand, 57 percent in Denmark, and 54 percent in Australia. Nations which collect either a very small part of their revenues from social security taxes or none at all tend to derive a large share of their revenues from taxes on income.

Income taxes furnish about 39 percent of tax revenue in the 23 OECD countries combined. The U.S. share — 43 percent — ranks ninth highest.

France and Greece raised the least through individual income taxes at 13 and 14 percent respectively. By contrast, New Zealand derived 60 percent of its tax collections from this source. Denmark also raised more than half of its revenues from individual income taxes. The United States, ranked seventh among the member countries, raised 36 percent of all revenues through the personal income tax.

Corporate profits tax levies also generate significant public revenue for most of the member countries.

(Continued on page 5)

**Percentage Distribution of Tax Revenues in Selected Countries by Source**
**Fiscal Year 1985**

| Country | Taxes on Income and Profits[a] |  | Social Security Taxes[b] | Taxes on Goods and Services |  |  | Property Taxes[d] | Other and Unallocable[e] | Total Tax As % Of GDP | Per Capita Taxes[g] |
|---|---|---|---|---|---|---|---|---|---|---|
|  | Individ. Income | Corp. Profits |  | Total[c] | Consumption Taxes: General | Consumption Taxes: Specific |  |  |  |  |
| Australia | 45.1% | 9.2% | - | 32.5% | 7.9% | 20.3% | 7.7% | 5.5% | 30.3% | $3,213 |
| Austria | 23.1 | 3.3 | 31.8% | 32.6 | 21.0 | 10.4 | 2.4 | 6.8 | 42.5 | 3,714 |
| Belgium | 34.1 | 6.4 | 33.2 | 24.4 | 15.7 | 7.0 | 1.7 | 0.2 | 46.9 | 3,854 |
| Canada | 35.5 | 8.2 | 13.3 | 31.5 | 13.2 | 12.6 | 9.5 | 2.0 | 33.1 | 4,621 |
| Denmark | 50.2 | 4.8 | 3.8 | 34.2 | 20.0 | 12.9 | 4.3 | 2.7 | 49.2 | 5,573 |
| Finland | 46.6 | 4.0 | 9.0 | 36.7 | 21.2 | 15.1 | 3.0 | 0.7 | 37.3 | 4,116 |
| France | 12.7 | 4.3 | 43.6 | 29.4 | 19.9 | 8.7 | 4.6 | 5.4 | 45.6 | 4,216 |
| Germany | 28.7 | 6.1 | 36.5 | 25.6 | 15.8 | 8.7 | 3.0 | 0.1 | 37.8 | 3,869 |
| Greece | 14.0 | 2.7 | 34.9 | 43.3 | 17.2 | 21.5 | 2.7 | 2.4 | 35.1 | 1,178 |
| Ireland | 31.3 | 3.2 | 14.8 | 44.5 | 20.6 | 22.0 | 3.8 | 2.4 | 39.1 | 2,005 |
| Italy | 26.7 | 9.2 | 34.7 | 25.4 | 14.5 | 9.1 | 2.5 | 1.5 | 34.7 | 2,565 |
| Japan | 24.8 | 21.0 | 30.2 | 14.0 | - | 12.1 | 9.7 | 0.3 | 28.0 | 3,107 |
| Luxembourg | 26.3 | 18.2 | 25.5 | 23.9 | 12.8 | 10.5 | 5.6 | 0.5 | 42.8 | 4,748 |
| Netherlands | 19.5 | 7.0 | 43.9 | 25.8 | 16.3 | 7.3 | 3.5 | 0.3 | 45.0 | 3,879 |
| New Zealand | 60.0 | 8.4 | - | 23.2 | 10.4 | 11.7 | 7.1 | 1.3 | 34.3 | 2,304 |
| Norway | 22.5 | 17.0 | 20.6 | 37.5 | 18.2 | 18.2 | 1.7 | 0.7 | 47.8 | 6,668 |
| Portugal | f | f | 26.0 | 42.5 | 12.6 | 28.4 | 1.9 | 25.9[f] | 31.1 | 676 |
| Spain | 22.6 | 5.5 | 41.5 | 26.4 | 14.1 | 12.4 | 2.8 | 1.2 | 28.8 | 1,226 |
| Sweden | 38.5 | 3.5 | 24.8 | 26.4 | 13.9 | 11.4 | 2.3 | 4.5 | 50.5 | 8,064 |
| Switzerland | 34.8 | 5.9 | 32.1 | 18.9 | 9.3 | 8.2 | 8.2 | 0.1 | 32.1 | 4,554 |
| Turkey | 33.7 | 11.6 | 5.1 | 44.0 | 28.5 | 15.1 | 5.6 | - | 16.1 | 170 |
| United Kingdom | 26.0 | 12.9 | 17.5 | 31.6 | 15.9 | 13.9 | 12.0 | - | 38.1 | 3,025 |
| United States | 35.7 | 7.1 | 29.4 | 17.7 | 7.4 | 7.9 | 10.1 | - | 29.2 | 4,740 |

[a] Includes taxes on capital gains.

[b] Includes taxes on self-employed.

[c] Includes import duties, profits on public fiscal monopolies, licenses, and other business taxes.

[d] Includes taxes on movable and immovable property, net wealth taxes, and estate and gift taxes.

[e] Includes general and selective taxes on payrolls which are not earmarked for social security purposes, and other taxes not elsewhere classified.

[f] Income and profit taxes are 25.9% of total taxes and are included under "other and unallocable", as they are not segregable between individuals and corporations.

[g] In U.S. dollars.

Source: Organization for Economic Cooperation and Developement.

## Tax Features

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*Budget Watch*

# Federal Spending Jumps Trillion Dollar Hurdle

The Tax Foundation was established 50 years ago during the brief period between the Great Depression and World War II. The first of these crises led to the modern welfare state, the second to massive increases in defense spending. The growth of the Federal government has been a continuing story, however, which certainly did not end with these long-ago events. When the Foundation opened its doors, Federal spending was less than $10 billion a year; in the latest fiscal year, it exceeded a trillion dollars.

This article reviews the growth in expenditures during the past 50 years and discusses the implications for the Federal budget. The upward trend is summarized in Table 1 which displays total spending at 10-year intervals since 1938. The data show an incessant rise in Federal spending: in each of the selected years, spending has been higher than it was 10 years earlier. There have been few downturns in Federal spending, and all but one of these occurred after the cessation of war.

Inflation has accounted for a substantial portion of the spending increase, but the escalation is quite pronounced even when an adjustment is made for rising costs. Table 1 shows that in constant (inflation-adjusted) dollars outlays are 15 times higher than a half century ago. This trend has persisted in the 1980s despite widely-publicized claims of cutbacks in Federal spending. In constant dollars, fiscal 1987 spending exceeded the fiscal 1977 level by $200 billion. This is the largest real increase during any decade in American history.[1]

There has also been a steep rise in relative spending, that is, in Federal outlays as a percentage of the gross national product (GNP). In the late 1930s, Federal outlays amounted to about 7 percent of GNP. The percentage had been much lower just a few years earlier, prior to the New Deal. Since then, relative spending has moved steadily upward; at almost 23 percent of GNP, it is now three times what it was a half a century ago.

The upward spiral in expenditures has been accompanied by a similar development on the revenue side of the budget. Revenues totaled 19 percent of GNP in the 1987 fiscal year, compared to only 6 percent 50 years earlier. But revenue growth has lagged somewhat behind that of expenditures and, as a result, budget deficits and the public debt have soared. In some recent years, the budget deficit has exceeded 5 percent of GNP, pushing total public debt to more than $2.5 trillion, and greatly increasing per capita debt (see chart below).

An understanding of the dynamic growth of Federal spending would be enhanced by reviewing developments in each of the past five decades.

### 1938–1947

By the late 1930s, the New Deal had turned emergency relief into permanent programs. The financial burden was modest at the outset — but the basis had been laid for a much larger Federal government in the future. Spending pressures during this decade were almost entirely war-related. Defense spending began to rise in the late 1930s and peaked in 1945 at almost 40 percent of GNP. Nondefense spending declined, both because economic recovery diminished the need for relief and because full mobilization dictated that resources not be diverted from the war effort. After the war, Federal outlays dropped sharply to only 12 percent of GNP in 1948.

### 1948–1957

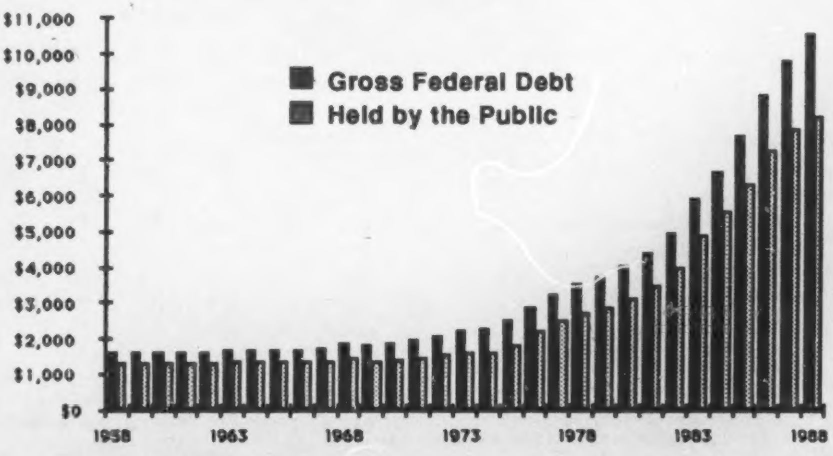
This period left an enduring imprint on Federal expenditures. The protracted cold war meant that defense spending would be maintained at a high level even in peacetime. Although the United States was not at war in 1957, defense claimed almost 60 percent of total outlays. Except for the Interstate Highway Program, the Eisenhower Administration did not undertake major domestic expansions. But neither did it roll back the New Deal programs. The social innovations of the 1930s were accepted as a legiti-

**Table 1**
**Total Federal Outlays in Current and Constant (1982) Dollars and As a Percent of GNP, Selected Fiscal Years, 1938–1987**
**($billions)**

| Fiscal Year | Total Outlays | Outlays As % Of GNP | Outlays in Constant 1982 Dollars |
|---|---|---|---|
| 1938 | $ 6.8 | 7.7 | $ 60.0 |
| 1947 | 34.5 | 15.4 | 212.8 |
| 1957 | 76.6 | 17.4 | 318.8 |
| 1967 | 157.5 | 19.8 | 488.7 |
| 1977 | 409.2 | 21.2 | 622.6 |
| 1987 | 1,016.9 | 23.0 | 862.9 |

Sources: The 1938 data are adapted from the Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970;* the data for 1947–1977 are from the Office of Management and Budget, *Historical Tables;* and the 1987 estimates are from the Office of Management and Budget, *Mid-Session Review of the 1988 Budget.*

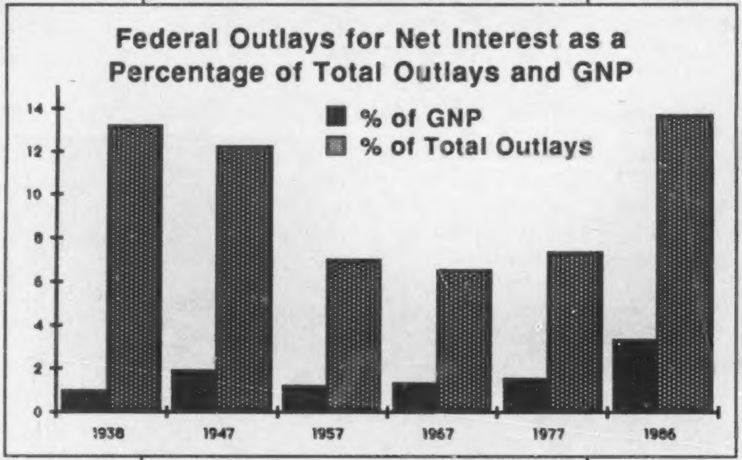
**Per Capita Federal Debt at End of Year 1958—1988**



mate, continuing responsibility of government in the 1950s.

### 1958-1967

The Kennedy-Johnson years opened a new expansionary era in Federal budgeting. Expansion was spurred by the adoption of dynamic fiscal policies which called for tax cuts and spending increases to stimulate economic growth and by the enactment of ambitious Great Society legislation. These did not cost much at the start but some of them (especially Medicare and Medicaid) would become increasingly prominent in the future. During the first part of the 1960s, a vigorous economy made it possible for the government to expand without increasing its share of GNP. But escalation of the Vietnam War put pressure on the budget and produced a guns versus butter debate which has persisted for the past 20 years.


Federal Outlays for Net Interest as a Percentage of Total Outlays and GNP

### 1968–1977

This period represented the end of the postwar boom during which economic growth had averaged more than 4 percent a year and the beginning of an austere period characterized by slower growth, higher unemployment, and bigger deficits. At first, various transfer programs, such as food stamps and social security, were enlarged, and a new sense of federalism led to the first revenue sharing program with the states and localities. Later, Congress established a new budget process in an effort to control Federal spending and deficits. Judging from the results, the new process has not been particularly successful.

### 1978-1987

The most recent decade has been dominated by the Reagan revolution, an attempt to rearrange budget priorities by building up defense forces, curtailing domestic spending, and reducing income tax rates. After startling success in his first year, the President has been locked in a protracted budgetary stalemate with Congress. Defense spending climbed rapidly in the early 1980s but has leveled off in recent years. Discretionary domestic programs have been cut back, but nowhere near the extent sought by the Administration, and transfers continue to claim a rising share of the budget. This has resulted in massive deficits and the enactment of the Gramm-Rudman-Hollings process which seeks a balanced Federal budget by the early 1990s.

## The Changing Composition of Federal Spending

Over the years, the composition of expenditures has undergone considerable change. Table 2 traces five categories of expenditure: defense programs, payments for individuals, grants to state and local governments, interest charges, and other (mostly discretionary domestic) programs. The trend is unmistakably clear: payments for individuals have become the most prominent part of the budget. Fifty years ago, these payments were barely one billion dollars; today, they total almost $500 billion and account for almost half of total Federal spending. Most of these payments are in the form of entitlements, which obligate the government to provide financial assistance to persons who meet the eligibility requirements established in law.

In addition to these payments, the budget finances two other types of transfers: interest charges and grants to states and localities. Recent deficits have compelled the government to allocate a rising share of the budget to interest payments. As the chart above demonstrates, almost 14 percent of the budget goes to pay interest on the public debt, just about twice the percentage of a decade ago.

Grants have had a roller coaster ride in the Federal budget. During the

*(Continued on page 6)*

### Table 2

**Types of Federal Outlays in Current Dollars and As Percentages of Total Outlays, Selected Fiscal Years, 1938-1986**
**($billions)**

| Outlay | 1938* | | 1947 | | 1957 | | 1967 | | 1977 | | 1986 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | $ | % | $ | % | $ | % | $ | % | $ | % | $ | % |
| Defense | 1.0 | 14.7 | 12.8 | 37.1 | 45.4 | 59.3 | 71.4 | 45.3 | 97.2 | 23.8 | 273.4 | 27.6 |
| Payments for Individuals | 1.1 | 16.2 | 9.1 | 26.4 | 17.0 | 22.2 | 43.2 | 27.4 | 196.3 | 48.0 | 448.0 | 45.3 |
| State-Local Grants** | 0.5 | 7.4 | 0.8 | 2.3 | 2.2 | 2.9 | 10.4 | 6.6 | 46.1 | 11.3 | 60.8 | 6.1 |
| Net Interest | 0.9 | 13.2 | 4.2 | 12.2 | 5.4 | 7.0 | 10.3 | 6.5 | 29.9 | 7.3 | 136.0 | 13.7 |
| All other | 3.2 | 47.1 | 9.1 | 26.4 | 10.7 | 14.0 | 29.5 | 18.7 | 54.5 | 13.3 | 104.7 | 10.6 |
| Offsetting Receipts | n.a. | n.a. | -1.5 | -4.3 | -4.1 | -5.4 | -7.3 | -4.6 | -14.9 | -3.6 | -33.0 | -3.3 |

Sources: Same as Table 1.

* Because of the different sources, 1938's figures are not strictly comparable to those for later years.

** Amounts shown for grants do not include grants which finance payments for individuals. Outlays for these grants are included in the payments for individuals category.

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SPECIAL REPORT

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# *Lotteries: Entering the Big Time In State Finance*

**By John Hanly Adams**
Editorial Consultant
Tax Foundation

Like it or not — and millions of Americans hate the idea on moral or other grounds — state owned and operated "numbers games" known better as lotteries are a growing part of the financial support for state and local governments in the U.S.

The latest available facts and figures on the increasing financial reach of government-sanctioned gambling are presented in this Tax Foundation Special Report. They show:

- A total of 22 states and the District of Columbia took in $12.5 billion in lottery sales, producing almost $5 billion in net lottery income, after expenses and prizes, in the fiscal year ended June 30, 1986. Net lottery income for all states has been growing at 29% per year since FY 1980, accelerating to 36% per year since FY 1984. Five additional states approved lotteries in fiscal year 1987. Virginia voters approved a lottery on November 3 and several other states are considering proposals. About three-fourths of the U.S. population now is exposed to state-operated games.
- Lotteries still are a small share of states' total income and charges — 1 to 5 percent of the revenue from state taxes and charges in FY '86 — and profits vary far more, and more unpredictably, than tax revenues. But lotteries' input, and thus their clout at state capitals, is growing. Lotteries brought in more revenue than tobacco and alcohol sales taxes last year in California, New York and eight other states and D.C.
- State lotteries also remain a small part of the gambling financial scene, in terms of dollars. Guesses about the total value of gaming and wagering vary wildly, especially as to the extent of illegal betting in its many forms. One educated guesstimate puts the total "handle" at $199 billion in 1986. In terms of people taking part — a crucial measure

**Lotteries Spread, coast to coast —**

In 1963 one state, New Hampshire, authorized the first modern state lottery.

WASH
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MINN
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WYO
WIS
MICH
CAL
NEV
IDA
UTAH
NEBR
IOWA
ILL
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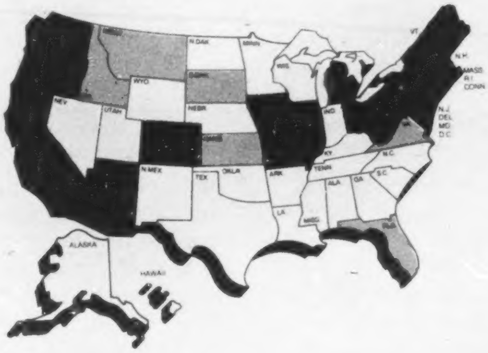
HAWAII

Now, in 1987, 22 states and the District of Columbia operate lotteries and 6 others are starting them. Other states are debating the issue.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HAWAII

**Lotteries' Rise in the gambling world —**

State-owned and operated lotteries have become the fastest growing form of public betting in the U.S. Lottery ticket sales have quadrupled in the last five years, reaching $12.5 billion in the year ended June 30, 1986. But this apparently is only a fraction of the total gambling "handle" (the estimated aggregate sum of all money changing hands in public wagering). Casino table games and slot machines licensed by various states remain the King Kongs of gambling. See the chart on the next page for a perspective on that part of the story.

Map data from "1987 U.S. Gaming Industry" report by Laventhol & Horwath, CPAs.

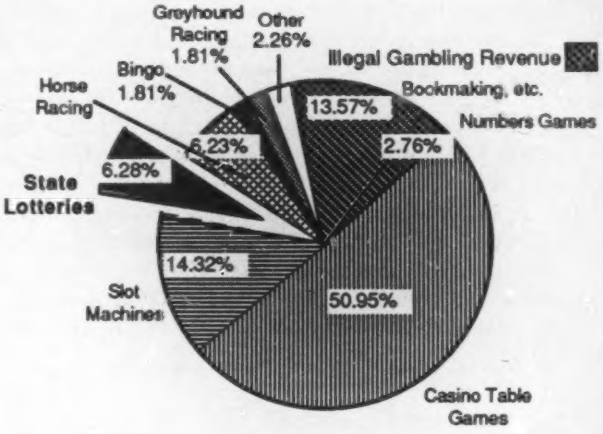
## *One Measure of the Gambling Industry*

No recent official estimates of gambling finances in the U.S. have been published. A presidential commission on law enforcement estimated illegal gambling at $20 billion a year in 1967, and in 1974 the U.S. Department of Justice put the illegal total at $29 to $39 billion. An unofficial estimate of all gambling action is published annually by Gaming & Wagering Business, a monthly magazine. From its latest study, in the July 1987 issue, by Eugene Martin Christiansen, an economist and Special Assistant to the New York City Off-Track Betting Corp. —

> "Aggregate gambling in American commercial games reached $199 billion in 1986; a $7.9 billion, 4.2 percent increase over 1985. The number is an all-time high. It is also partly illusory. More than half that $199 billion was the ebb and flow of chips across casino tables; high-velocity gambling that makes the churn of dollars through parimutuel machines slow and lotto games glacial in comparison. Another $25.2 billion were not physical dollars at all, but credits and debits in telephone transactions between American sports and racing fans and the operators of illegal books. Most of the residue, though, some $72 billion, was real currency and coins, handled through track and OTB (Off-Track Betting) totalizers, slot machines, lottery agencies, bingo halls and the Las Vegas Night craps game at local churches and synagogues. That wad of cash made gambling a major component of the U.S. leisure economy . . ."

### Gambling Dollars, Fiscal Year 1986

| | $Billions | % of Total |
|---|---|---|
| Total "Handle" | 199.0 | 100.00 |
| Legal gambling | 166.5 | 83.67 |
| Casino table games | 101.4 | 50.95 |
| Slot machines | 28.5 | 14.32 |
| State lotteries | 12.5 | 6.28 |
| Horse racing | 12.4 | 6.23 |
| Bingo | 3.6 | 1.81 |
| Greyhound racing | 3.6 | 1.81 |
| Other | 4.5 | 2.26 |
| Illegal gambling | 32.5 | 16.33 |
| Bookmaking, etc. | 27.0 | 13.57 |
| Numbers games | 5.5 | 2.76 |



Basic Data: Gaming & Wagering Business

of gambling's influence on the economy and politics — state lotteries now are by far the leading form of commercial gambling and the fastest growing.

Latest sign of lotteries' growth came on November 3 when a state game was approved by Virginia, often considered a bellwether for the Old South. That tier of states, except for non-typical Florida, had been the only regional hold-out against lotteries. Another victory for legalized gambling came in Texas, which approved state-sanctioned horse racing and betting for the first time in modern times. With these cracks in the South's front against gambling, the stage is set for a new phase in the hassles over gambling's role in public finances.

Re-play of history. Today's scene is a replay of 19th Century American history, to some extent. Lotteries to raise money for public purposes were common in colonial times. The early Harvard and Yale universities were financed in part with lottery proceeds. The Continental Congress approved a lottery to finance the American Revolution but it failed; the Tories had most of the money.

By the 1830s a number of states had approved various types of lotteries. They generally were state franchises, privately and loosely administered by "lottery contractors" (who included the forerunners of today's Chase Manhattan Bank and Citicorp) and scandals crept into the system. In the aftermath, most states adopted sweeping anti-gambling laws, often embedded in the constitutions of new states. Lotteries, as state-blessed ventures, disappeared.

The Federal government took the stance that gambling was a societal phenomenon and a state responsibility. Enforcement of state laws and local ordinances prohibiting gambling, however, proved to be sporadic and ineffective.

Illegal betting flourished, more or less openly, virtually everywhere. The illegal "numbers" racket, born in New York City's Harlem in the early '20s, proliferated into most big cities, especially after Prohibition ended in 1933 and bootleggers had to find a new field to exploit.

Gambling's Revival. The breakthrough for a return to legalized gambling came in 1931 when Nevada, desperate for revenue after mining's collapse in the Depression, became the first state to legalize casinos offering roulette and other wagering games, with the state government an active partner in supervising operations and sharing in the profits.

Other states in the East and Midwest followed that lead by authorizing similar partnerships in pari-mutuel horse racing (where pools of bettors place their opposing bets, and the track takes a percentage, paying part of that to the state usually in the form of license fees and taxes).

The Federal government got into the action through income taxes on bettors' winnings, plus "occupation" taxes on professional full-time gamblers and slot machines. The latter never produced as much revenue as predicted.

After the troops came home from World War II, wagering grew faster and faster. Illegal gambling became big business, increasingly intertwined with nationwide criminal syndicates and local political corruption. That brought limited Federal intervention in the form of statutes aimed at interstate transmission of gambling information and equipment, mainly useful as leverage against criminals active in drugs, prostitution, "protection" and other mob rackets.

**The Lottery Parade.** Then, in 1963, the New Hampshire legislature, confronting a state constitutional bar to an income tax, authorized a twice-a-year sweepstakes on horse race results, with the proceeds dedicated to public education. That was the start of the modern fling with state owned and operated lotteries as an integral part of the states' public finances.

New Hampshire's maiden venture was a financial flop at first, and nearly died when neighboring New York began a competing monthly sweepstakes in 1967. The New York operation also failed at first, and was marred by political patronage squabbles which led to its suspension in 1975-76.

But with aggressive marketing and ingenious designs of new games, the early lotteries became financial successes — and politically contagious. In state after state, lottery forces succeeded in getting the issue on statewide election ballots, and usually won by robust margins.

Opponents argued that lotteries are a regressive tax, in effect, bearing hardest on low-income players least able to pay; that lotteries breed gambling fever which creates more compulsive gamblers, fosters a breakdown of public morality and spreads criminal influences in a state's economy and politics. Supporters argued that the public will gamble, one way or another; that voters like lotteries, that participation is voluntary and the money goes for good causes.

Supporters have prevailed, up to now, hitting a peak in 1984 when all four states that had a lottery proposal on the ballot, including California, approved them. North Dakota, however, rejected a lottery in 1986.

**Next: Super Jackpots, VDTs.** As more states jump into lotteries, competition grows for players and dollars, spurring heightened promotion and marketing drives by lottery agencies, manufacturers of the machines involved, advertising experts, community vendors of tickets.

One major ploy is to increase the size of winnners' prizes as much as possible within the limits imposed by the mandatory level of paybacks to the customers (typically around 50 percent compared with the pari-mutuels' payout rate of around 80 percent), operating costs, and the pressure to meet revenue goals. Lotteries are highly leveraged. After the break-even point, profits are rich. This is leading to multi-state lotteries, which greatly enlarge the pool of players and the potential jackpots for winners.

First was the New England Tri-State game launched in 1985 by Massachusetts, New Hampshire and Vermont. Latest is "Lotto America," announced in Washington September 16. Taking part with the District of Columbia will be

## Lotteries as Revenue Raisers
### ($ in millions)

- **Lotteries' net is small compared with total state revenues. In fiscal year 1986 —**

| | | | Net Lottery Income | |
|---|---|---|---|---|
| States with Lotteries | Lottery Sales | Net Lottery Income After Prizes, Expenses | As % of All State Taxes (Property, Income, Sales, etc.) | As % of All Own-Source State Revenue† |
| AZ | 121.0 | 42.3 | 1.3% | †† |
| CA(1) | 1,765.6 | 692.7 | 2.2 | 1.5 |
| CO | 111.3 | 28.4 | 1.2 | †† |
| CT | 429.1 | 190.9 | 5.0 | 3.7 |
| DE | 40.9 | 16.7 | 1.9 | 1.2 |
| DC | 118.7 | 35.9 | 2.1 | N.A. |
| IL | 1,284.2 | 540.2 | 5.5 | 3.9 |
| IA(2) | 81.7 | 25.9 | 1.0 | †† |
| ME | 38.8 | 11.8 | 1.0 | †† |
| MD | 718.3 | 323.8 | 6.9 | 4.8 |
| MA | 1,397.9 | 439.8 | 5.7 | 4.8 |
| MI | 999.4 | 415.1 | 4.4 | 3.1 |
| MO(3) | 81.1 | 207.0 | 2.2 | 4.0 |
| NH | 33.8 | 10.7 | 2.2 | 1.0 |
| NJ | 900.1 | 418.2 | 5.0 | 3.2 |
| NY | 1,317.0 | 607.9 | 2.7 | 1.6 |
| OH | 940.0 | 383.6 | 4.2 | 2.6 |
| OR | 87.4 | 26.5 | 1.4 | †† |
| PA | 1,320.0 | 539.2 | 5.0 | 3.3 |
| RI | 56.9 | 21.6 | 2.4 | 1.3 |
| VT | 12.4 | 3.3 | 0.1 | †† |
| WA | 181.2 | 73.0 | 1.4 | †† |
| WV(4) | 53.0 | 21.0 | 1.1 | †† |

(1) Lottery began October 1985
(2) Lottery began August 1985
(3) Lottery began January 1986
(4) Results for period of April 1985 (when lottery began) through June 1986
† Excludes Federal grants, "Intergovernmental" transfers
†† Less than 1%

- **Yet lotteries now bring in more revenue than tobacco and alcohol sales taxes in 10 states and the District of Columbia — a trend closely watched by state finance officers who are worried about the future of tobacco/alcohol sales, and prospective declines in the revenues they generate.**

Iowa, Kansas, Missouri, Oregon, Rhode Island and West Virginia. The jackpots are expected to reach $10 to $20 million. Promoters hoped California and New York would join, and they may yet. That could bring jackpots up to $80 million or more.

As a lottery's size swells, so do the odds against winning, rising to the tens-of-million-to-1 class, and that might turn off the public. So far the lure of larger prizes seems to enlarge the "play" — and profits.

Another coming idea, already being tried in some places, is lottery games played on video display terminals (VDTs). This provides the elements of player participation and instant payoffs; proven inducements to gamble as shown by the popularity of slot machines ("one armed bandits") and pinball machines.

Eventually, as the interstate connections of lotteries and their suppliers increase, there could be moves in Congress to regulate, if not prohibit, the growing lottery industry. A sizable scandal in lotteries' management, involving prominent politicians and frauds on the public, could touch off that kind of reaction.

**"Constant tug of war."** The most thorough study of gambling in America, legal and illegal, was three years of investigation and hearings by a commission created by Congress in 1970 anti-crime legislation. In its 1976 final report the Commission made these points:

- "Gambling is inevitable. No matter what is said or done by advocates or opponents of gambling in all its forms, it is an activity that is practiced, or tacitly endorsed, by a substantial majority of Americans . . .
- "Because it is a social issue, the Commission has determined that gambling policy is the proper responsibility of the government entity closest to the lives of citizens — the State . . ."
- "Current gambling policy at the State level accurately reflects the ambivalence and contradiction that have traditionally characterized this nation's approach to the problem of gambling. The States often have found it difficult to formulate reasonable and consistent gambling policy and law. Over the years, two strong, conflicting sentiments have surfaced: That gambling is a morally and socially destructive activity that must be suppressed, and that the enormous popularity of gambling makes it a suitable activity for government to channel into useful and productive ends through licensing and taxation. The history of gambling policy in the United States has been a constant tug of war between these two philosophies, in which each side appears to gain the advantage for a certain period and then begins to lose ground . . ."

## A FEDERAL NATIONAL LOTTERY ?

Some members of Congress and high-level officials of the Reagan Administration have cast covetous glances at the money flow generated by state-operated lotteries.

The idea keeps cropping up that maybe a national lottery could bring billions of dollars into a Federal treasury that is deeply in the red. In lottery backers' dreams, the profits would be dedicated to deficit reduction or other worthy goals, such as improved education or medical care for the indigent or homeless housing.

The list of possible uses for any Federal lottery income is long; but the list of open supporters is short, as of autumn, 1987.

**In Congress,** 5 members of the House have introduced 7 bills (Rep. Cardiss Collins of Illinois made 3 proposals) that if enacted would authorize a national lottery of some type. The House Ways & Means Committee had scheduled no hearings on these bills at the time of this report.

**At the Treasury Department,** Secretary James Baker reportedly has showed some interest in lottery revenue possibilities. But in its only recent public comment, the Treasury replied negatively to a suggestion that the IRS operate a lottery with tax-exempt prizes, for deficit reduction.

**At the White House,** members of advisory groups such as the Domestic Council talk, at times, of the dollars a successful 50-state lottery might bring in. But it's just talk so far. The states, it is assumed, would rise up in united wrath if "the Feds" tried to move into the lottery money trough.

In short: National politicians apparently feel they have enough problems without dabbling in gambling. A Department of Army trial balloon for a sweepstakes at overseas posts to benefit Army welfare funds was floated in late '86, and shot down as soon as it ascended to higher, and more politically sensitive, heights. By contrast, the Treasury Department stoutly defends its gambling taxation turf, including income-tax withholding on state lottery winners' prizes above $500, for example.

Note: Sources for this report included "Gambling in America," Final Report of the Commission on the Review of the National Policy Toward Gambling (published by Government Printing Office in 1976, now out of print); "The Business of Ris$k" by Abt, Smith and Christiansen (published by University Press of Kansas in 1985); "Implicit Taxation in Lottery Finance" by Clotfelter and Cook, Working Paper 2246 (published by National Bureau of Economic Research Ins., in 1987).

(OECD, *from page 2*)

Japan raised over one-fifth of its 1985 receipts by taxing corporate incomes, ranking highest among the OECD nations. Seven percent of total tax receipts were derived from corporate income taxes in the United States in 1985, close to the OECD average of 8 percent. At the low end, Greece raised just under 3 percent of its revenues by taxing corporate income.

Taxes on goods and services (sales or consumption levies) are second to income taxes as revenue-raisers in OECD countries. They provide an average of 30 percent of tax revenues. Governments in the United States raise just 18 percent of total receipts from such taxes, placing the U.S. 22nd among the 23 OECD members in terms of reliance on consumption taxes. Japan's consumption tax is the lowest of the OECD nations at 14 percent while Ireland gets 45 percent of its total tax revenue by taxing goods and services.

Social security levies follow income and consumption taxes as the third largest revenue source for OECD countries, providing about 24 percent of all tax receipts. Variations from country to country are significant, however. Australia and New Zealand do not levy social security taxes. Denmark gets less than 4 percent of its revenue from such taxes. By contrast, social security taxes accounted for more than 41 percent of total tax revenues in France, Spain, and the Netherlands. The United States ranked in the middle range, 11th among OECD countries, getting 29 percent of its taxes from social security collections. However, social security taxes in the U.S. have increased substantially from 16 percent of total tax revenue in 1965 to 29 percent in 1985.

Property taxes generally are not a major source of tax revenue among OECD nations, providing 5 percent of total taxes on average. In 1985, the United Kingdom ranked first in its reliance on property taxes (12 percent of total), followed by the United States and Japan at 10 percent.

Another way to compare tax systems among the major industrialized countries is to examine the size of their tax receipts in relation to economic production. The OECD measures this by gross domestic product, or GDP.

The ratio of tax revenues to gross domestic product averages 37 percent in the 23 OECD countries. By this measure, Sweden is the "most taxing" nation, with receipts coming to just over 50 percent of GDP in 1985. Denmark ranks second at 49 percent. U.S. taxes in 1985 cames to 29 percent of GDP, placing this country 20th among its OECD affiliates. At the low end were Japan and Turkey at 28 and 16 percent of GDP, respectively.

The table and chart on page 2 provide further details on the distribution of tax revenues in selected countries for fiscal year 1985.

## THE FRONT BURNER

**By Robert C. Brown**
**President, Tax Foundation**

### "The Yankee Trader — An Endangered Species?"

The Yankee Trader used to be the prototype of the enterpreneurial spirit, roaming the seven seas with American made goods in American made vessels manned by American sailors. Indeed, the right to make and sell goods to export markets was one of the issues behind the American revolution.

Well, as the songwriter says, "the times they are a-changin'." The trade deficit is one of the two chief millstones around the neck of the American taxpayer. (The other, of course, is the budget deficit, although it begins to look as if we may finally see some concrete progress toward real deficit reduction by the time this publication is off press.) Our balance of payments is a disaster. Our merchant marine is a shadow of its former self. We are not even capitalizing on our own technological breakthroughs. (We developed the VCR; only Japan makes and sells it.)

What is the solution the U. S. Congress threatens to foist on U.S.–based multinationals? A protectionist trade bill that will only worsen the situation. In the face of a major threat that our status as a world trader is becoming second rate, all Washington can do is close the borders, inviting retaliation by the other players in the game. To call such a step counterproductive is to overstate the obvious.

Where does the real solution lie? On September 18 of this year, the Wall Street Journal published a market valuation ranking of the world's 100 largest public companies. The U.S. could lay claim to 40 of those top slots. Not so bad, you might say, in this age of growing world economic unity. Maybe. Japan, which was literally on its knees just 30 years ago, owned 44 of the top 100. All other nations — Great Britain, West Germany, France, Korea, Taiwan, and any other you care to name — were, as mathematicians say, statistically insignificant.

Why this astounding fall from grace for the Yankee trader? Trade policy is a partial explanation. Another reason is tax policy. The United States does not — as do Japan, West Germany, The Netherlands, and others — encourage multinationals to be aggressive in developing overseas markets. Instead, we tax them so heavily that it is hardly profitable for them to compete. From a tax policy perspective, there are those who would say you were crazy if you started a multinational corporation and based it in the United States. A major improvement would be simply to treat our multinationals the way other major trading nations do.

In the key area of world trade competitiveness, tax policy driven almost exclusively by revenue considerations is causing side effects that are very, very harmful.

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(FEDERAL SPENDING, *from page 4*)

postwar era, they escalated to more than 10 percent of total spending. Over the past decade, however, their share has shrunk to 6 percent, and they now comprise approximately the same portion of spending as they did in the mid-1960s. As noted in Table 2, the amounts shown for these grants do not include payments for individuals (such as medicaid and aid to families with dependent children) which are passed through state or local governments. These payments now comprise half of all total grants to states and localities.

Defense is another category that has gone through ups and downs. Between 1957 and 1977, defense dropped from almost 60 percent to less than 25 percent of Federal spending. The recent buildup has increased the defense share of the budget, but it still is much lower than it was after World War II.

Discretionary domestic spending — the "all other" category — has been least successful in the competition for Federal dollars. This category accounted for almost half of total spending in 1938; it now gets only about 10 percent. This part of the budget finances the ongoing operations of Federal agencies, including such diverse and well-established activities as the national parks, health research, and space exploration.

Both payments for individuals and interest costs are forms of transfers from the Federal government to outside recipients of public funds. Together, they comprise almost two-thirds of the budget. The growth of these transfers has important implications for the Federal budget.

### Budgeting Now More Dependent On Economic Performance

When the Federal government began to use the budget in the postwar period as a key instrument of fiscal policy, transfers were seen as automatic stabilizers that would restrain the economy when it was overheated and stimulate it when it was weak. But the increasing impact of transfers has made their role in budgeting both structural and cyclical. Transfer spending rises when the economy is strong as well as when it is weak. Rather than the budget balancing the economy, the economy can unbalance the budget. In some recent years, more spending has been added to the budget by changing economic conditions than by discretionary policies.

### Annual Rise in Spending Mostly Due to Entitlements

Most transfers are mandatory entitlements whose level cannot be determined by budgetary or appropriation decisions alone. Unless the law establishing the entitlement is changed, the government must pay the required amount, regardless of economic conditions or other demands on the budget.

The cost of most entitlements goes up automatically, without any action by the President or Congress. The aging of the population, price changes, and other developments add greatly to annual transfer payments. Largely because of these entitlements, three quarters of the Federal budget is classified by OMB as "relatively uncontrollable under existing law." There is, of course, no inherent reason why Congress cannot control spending better by changing existing law. But it takes a great deal of political muscle to do so.

### Budgetary Power Redistributed In Congress

The rise of transfers has shifted spending power from the appropriations committees to authorizing committees. At one time, the appropriations committees had control of virtually all Federal expenditures. Today, however, these committees have jurisdiction over barely one-half of the budget and effective control of only one quarter. While authorizing committees, which have jurisdiction over legislation dealing with transfer programs, have enhanced their budget role, budgeting has become a more turbulent process as the numerous participants in the process vie for power.

The growth of transfers is not likely to be reversed, though it probably will be much slower in the next 50 years than it was in the past 50. The Federal government has had great difficulty adjusting its budget practices to this reality. The political deadlocks and budget deficits of recent years suggest that the necessary adjustments have not been made.

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TAX·FEATURES

# Slow Growth, Modest Inflation Seen By Conference Board Economist for 1988

## *U.S. Endures Two Decades of Accelerating Tax Legislation; Wobbling in Federal Policy*

The 22-year span between 1964 and 1986 has witnessed the most frequent and dramatic changes in the Federal tax system in history. Congress has enacted 16 major tax bills and dozens of lesser bills affecting Federal revenue levels. Of the 14 major tax acts presented in Table 1, five have, on balance, increased revenues, eight reduced them, and one, the Tax Reform Act of 1986 is estimated to be revenue neutral over the five-year period of 1987-91. The revenue amounts involved in these tax acts range from an estimated fiscal year reduction of $309 billion in 1990 under the original Economic Recovery Tax Act of 1981 (ERTA) to an estimated $60 billion increase in the same fiscal year under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

The individual, corporate, and total Federal revenue impact of major enacted legislation since 1964 appear in Table 1. Here the budget result of each tax act is presented in isolation without netting the effects of subsequent legislation. The total revenue impact includes all taxes and miscellaneous receipts and is also presented as a percentage of gross national product (GNP). The Office of Management and Budget prepares the budget effect revenue estimates each fiscal year for the purposes of the budget presentation. They measure only the direct effect of tax legislative changes on receipts, with "feedback" effect limited to the overall income forecast and its impact on receipts by major source. Unlike the original legislative intent estimates, budget effect estimates reflect actual economic experience or revisions in the economic forecast.

### Tax Reductions

The Revenue Act of 1964 and the Economic Recovery Tax Act of 1981 were by far the largest

*(Continued on page 2)*

### Economic Outlook for 1988

"The forecast has some good news and some bad news," economist Edgar R. Fiedler told some 275 attendees at the Tax Foundation's 39th National Conference in New York December 2. Fiedler, Vice President and Economic Counselor of The Conference Board, keynoted the conference's morning session with the traditional economic forecast for the coming year. Paul H. O'Neill, President and Chief Executive Officer of Alcoa and a member of the Tax Foundation's Shadow Committee on the Federal Budget, chaired the session.

"The good news," Fiedler observed, "is no recession and no accelerating in the current 4 percent inflation rate. The bad news is that neither I nor any of my fellow forecasters has any confidence in this forecast." "Even in the best of times, forecasting is a hazardous profession,"he noted, adding, "This is the worst of times."

The Conference Board's number one economist advised the corporate executives attending the Conference, "Keep your powder dry. That is, keep your company's plans flexible, ready to switch to a strategy suitable for either a weaker or a stronger economy in 1988 as the unfolding statistics reveal it, because right now, you can't trust your forecaster."

Nevertheless, Fiedler dutifully provided estimates of the major economic indicators for 1988, including: 2 percent increase in real GNP, 4 percent inflation, unemployment rising from about 6 percent now to 6 1/4 percent, or a little more, by the end of 1988, and interest rates not moving very much. "My own bet would be that interest rates will go up from here rather than go down, but not very far," he said.

### Deficits — A Double Threat

While Fiedler conceded that the budget deficit is "a very serious issue for the performance of the economy over the next decade or two," he questioned that it had much to do with the October 1987 collapse of the stock market. Rather, he argued, "longer term massive deficits pose two serious threats that cannot be ignored." In the first place, such deficits "present a constant temptation to try to inflate our way out of the problem by monetizing the deficits." The second threat, which he cited as "not so dramatic . . . but just as debilitating," is "the drain on our supply of savings that would otherwise be avail-

*(Continued on page 5)*

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**Discouraging Tax Package**

## Table 1

### Federal Revenue Impact of Major Enacted Tax Legislation, Fiscal Years 1964–1990

### Individual, Corporate, and Total Impact and Percentage of GNP (a)

### Budget Effect in Billions of Dollars (c)

| | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue Act of 1964** | -2.4 | -10.2 | -15.3 | -17.3 | -18.3 | | | | | | | | | | | | |
| Individual | -2.4 | -8.7 | -12.4 | -14.1 | -15.5 | | | | | | | | | | | | |
| Corporate | | -1.5 | -2.9 | -3.2 | -3.2 | | | | | | | | | | | | |
| Total as a percent of GNP | -0.38% | -1.52% | -2.07% | -2.18% | -2.15% | | | | | | | | | | | | |
| **Revenue and Expenditure Control Act of 1968** | | | | | | 16.0 | [illegible].7 | | | | | | | | | | |
| Individual | | | | | | 8.4 | 0.8 | | | | | | | | | | |
| Corporate | | | | | | 3.8 | 1.5 | | | | | | | | | | |
| Total as a percent of GNP | | | | | | 1.7[illegible]% | 0.47% | | | | | | | | | | |
| **Tax Reform Act of 1969** | | | | | | | 1.2 | 0.2 | -1.1 | -3.8 | -5.4 | | | | | | |
| Total as a percent of GNP | | | | | | | 0.12% | 0.02% | -0.10% | -0.28% | -0.37% | | | | | | |
| **Revenue Act of 1971** | | | | | | | | | -4.4 | -6.9 | | | | | | | |
| Individual | | | | | | | | | -1.9 | -2.9 | | | | | | | |
| Corporate | | | | | | | | | (b) | -1.7 | | | | | | | |
| Total as a percent of GNP | | | | | | | | | -0.38% | -0.54% | | | | | | | |
| **Tax Reduction Act of 1975** | | | | | | | | | | | | -10.2 | -10.8 | 0.4 | 2.8 | 3.2 | 3.4 |
| Individual | | | | | | | | | | | | -9.4 | -8.7 | -0.6 | -0.2 | -0.1 | -0.1 |
| Corporate | | | | | | | | | | | | -0.8 | -2.0 | 1.0 | 2.9 | 3.3 | 3.6 |
| Total as a percent of GNP | | | | | | | | | | | | -0.67% | -0.64% | 0.02% | 0.13% | 0.13% | 0.13% |
| **Tax Reform Act of 1976** | | | | | | | | | | | | | | -14.4 | -13.2 | -7.4 | -8.0 |
| Individual | | | | | | | | | | | | | | -13.2 | -8.7 | -3.8 | -3.9 |
| Corporate | | | | | | | | | | | | | | -2.6 | -3.5 | -2.4 | -2.5 |
| Total as a percent of GNP | | | | | | | | | | | | | | -0.74% | -0.61% | -0.30% | -0.30% |
| **Tax Reduction and Simplification Act of 1977** | | | | | | | | | | | | | | -2.6 | -17.8 | -13.7 | -5.8 |
| Individual | | | | | | | | | | | | | | -2.1 | -15.3 | -11.3 | -5.6 |
| Corporate | | | | | | | | | | | | | | -0.6 | -2.5 | -2.3 | -0.2 |
| Total as a percent of GNP | | | | | | | | | | | | | | -0.13% | -0.82% | -0.56% | -0.22% |

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988$^d$ | 1989$^d$ | 1990$^d$ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue Act of 1978** | -4.4 | -21.7 | -25.1 | -29.0 | -33.1 | | | | | | | |
| Individual | -3.4 | -15.3 | -17.7 | | | | | | | | | |
| Corporate | -1.0 | -6.3 | -7.3 | | | | | | | | | |
| Total as a percent of GNP | -0.18% | -0.81% | -0.84% | -0.92% | -1.00% | | | | | | | |
| **Crude Oil Windfall ProfitsTax of 1980** | | 3.9 | 13.0 | 18.4 | 18.8 | 21.0 | | | | | | |
| Total as a percent of GNP | | 0.15% | 0.44% | 0.59% | 0.57% | 0.57% | | | | | | |
| **Economic Recovery Tax Act of 1981** | | | -0.2 | -35.6 | -91.1 | -136.8 | -170.3 | -209.8 | -238.5 | -258.7 | -282.0 | -309.4 |
| Individual | | | -0.2 | -25.2 | -67.0 | -101.3 | -120.3 | -142.2 | -162.1 | -179.6 | -201.7 | |
| Corporate | | | (b) | -9.5 | -14.9 | -22.4 | -32.0 | -43.9 | -50.3 | -51.8 | -52.2 | |
| Total as a percent of GNP | | | -0.01% | -1.13% | -2.74% | -3.71% | -4.32% | -5.08% | -5.40% | -5.47% | -5.56% | -5.69% |
| **Tax Equity and Fiscal Responsibility Act of 1982** | | | | | 16.6 | 36.0 | 39.2 | 46.7 | 56.8 | 58.8 | 58.2 | 59.9 |
| Individual | | | | | 3.4 | 10.9 | 12.9 | 13.4 | 14.9 | 15.8 | 16.6 | |
| Corporate | | | | | 7.6 | 16.9 | 19.2 | 28.8 | 38.1 | 40.9 | 40.2 | |
| Total as a percent of GNP | | | | | 0.50% | 0.98% | 0.99% | 1.13% | 1.29% | 1.24% | 1.15% | 1.10% |
| **Social Security Admendments of 1983** | | | | | | 5.7 | 8.7 | 10.2 | 12.1 | 24.6 | 31.0 | 23.8 |
| Total as a percent of GNP | | | | | | 0.15% | 0.22% | 0.25% | 0.27% | 0.52% | 0.61% | 0.44% |
| **Deficit Reduction Act of 1984** | | | | | | 0.9 | 9.3 | 16.1 | 22.0 | 25.3 | 27.7 | 31.1 |
| Individual | | | | | | 0.7 | 5.6 | 8.0 | 10.2 | 13.1 | 16.0 | |
| Corporate | | | | | | 0.5 | 3.3 | 5.8 | 8.1 | 9.7 | 10.6 | |
| Total as a percent of GNP | | | | | | 0.02% | 0.24% | 0.39% | 0.50% | 0.53% | 0.55% | 0.57% |
| **Tax Reform Act of 1986** | | | | | | | | | 18.6 | 0.[illegible] | -11.7 | -9.0 |
| Individual | | | | | | | | | -10.6 | -27.4 | -38.8 | -38.5 |
| Corporate | | | | | | | | | 28.2 | 25.0 | 23.5 | 25.4 |
| Total as a percent of GNP | | | | | | | | | 0.42% | 0.02% | -0.23% | -0.17% |
| ***EXHIBIT*** | | | | | | | | | | | | |
| **Net budget effect of all major acts: 1981-1986** | | | | | | | | -132.4 | -117.5 | -136.4 | -164.4 | -193.1 |
| Individual | | | | | | | | -134.4 | -157.0 | -186.2 | -216.9 | -238.6 |
| Corporate | | | | | | | | -14.8 | 18.5 | 19.7 | 20.6 | 24.2 |
| Total net 1981-1986 as a percent of GNP | | | | | | | | -3.20% | -2.70% | -2.90% | -3.20% | -3.60% |

(a) Totals include all taxes and miscellaneous receipts.

(b) Less than $50 million.

(c) Budget effect revenue estimates are prepared by the Office of Management and Budget for purposes of the budget presentation. They measure only the direct effect of tax legislative changes on receipts with "feedback" effect limited to the overall income forecast and its impact on receipts by major source. Budget estimates reflect actual economic experience or revisions in the economic forecast; the original legislative intent estimates do not.

(d) Revenue and GNP projections from the Fiscal Year 1988 Budget of the United States Government (Supplement), February 1987.

Source: Office of Management and Budget, Budget of the United States Government for fiscal years 1964 through 1988.

(TAX LEGISLATION, *from page 1*)

tax revenue reductions as a percentage of GNP. The Federal revenue reductions from the Revenue Act of 1964 amounted to over 2% of GNP in 1966, 1967 and 1968, due primarily to huge reductions in individual tax revenues and only modest corporate tax reductions. In 1968, the 1964 act produced a $15.5 billion reduction in individual tax revenues and an additional $3.2 billion in corporate tax reductions.

Not until 1981 did Congress again enact cuts reducing total Federal tax revenues by more than 2% of GNP. With ERTA in 1981, estimated 1983 total Federal revenue reductions amounted to 2.7% of GNP and would have reached almost 7% of GNP by 1990 – making it the largest tax cut in history for both individuals and corporations *if* it had been allowed to take effect fully. Congress devised ERTA's tax cuts to result in roughly an 80%-20% split between individuals and business

*(Continued on page 8)*

**Budget Watch** By Allen Schick

# Lessons from the Budget Summit

Negotiating an arms control agreement with the Soviet Union is an easier task than negotiating a budget agreement between the President and Congress. For a full month, in October and November 1987, congressional leaders and presidential aides met day after day to iron out what appeared to be minor differences in revenue and spending policies. They finally hammered out an agreement that would, on paper, slice about $30 billion from this year's deficit and $46 billion from next year's. These seem to be big numbers, but when the smoke clears and the mirrors are taken away, what remains is *less* genuine deficit reduction than would have been accomplished by the automatic cutbacks of the Gramm-Rudman-Hollings (GRH) process.

## The New GRH Mode — More Promises, Fewer Cuts

About a month before the budget summit, Congress revised the deficit and cutback targets of the Gramm-Rudman-Hollings process, The changes lowered the amounts by which the deficit had to be reduced, postponed the goal of a balanced budget until 1993, and limited this year's required deficit reduction to $23 billion. The new timetable was intended to defer tough decisions until after the 1988 elections.

Then came Black Monday, the 500 point drop in the Dow Jones index on October 19, 1987. Almost immediately, the President agreed to meet with congressional leaders to negotiate an agreement that would avert sequestration under GRH and calm the markets. At that point, everything seemed "greased" for a quick end to the protracted stalemate that had blocked action on the deficit. Pressure for a settlement was overwhelming and the dollar gap between the two sides appeared to be quite small.

> ***. . . when the smoke clears, . . . what remains is less genuine deficit reduction than would have been accomplished by the automatic cutbacks of the GRH process.***

The $23 billion that the negotiators had to find in deficit reduction amounted to barely one percent of combined federal revenue and spending. Moreover, deficit reduction was computed against an inflated baseline; any spending below the baseline was counted as a cutback, even if it was above this year's level. Nevertheless, the executive and legislative branches battled over the cutbacks for a month. The agreement they finally announced purported to do more by way of deficit reduction than GRH cutbacks would have. Table 1 summarizes the agreement; it shows how little was really accomplished.

**Table 1**
**Budget Summit Agreement**
**($billions)**

| | 1988 | 1989 |
|---|---|---|
| **Total Deficit Reduction** | $30.20 | $45.85 |
| **Revenue Increases** | 17.40 | 22.40 |
| Taxes | 9.00 | 14.00 |
| User Fees & Other Charges | 1.80 | 2.00 |
| Tougher IRS Enforcement | 1.60 | 2.90 |
| Asset Sales | 5.00 | 3.50 |
| **Outlay Reductions** | 11.60 | 19.95 |
| Defense Cutbacks | 5.00 | 8.20 |
| Nondefense Discretionary Cuts | 2.60 | 3.40 |
| 2% Pay Increase (counted as a cut) | – | 2.40 |
| Entitlements | 4.00 | 5.95 |
| **Lower Debt Service** | 1.20 | 3.50 |

(Note: Estimated budget effects of the omnibus reconciliation bill as adopted in December 1987 differ marginally but not materially from this table.)

This table, which is arranged differently than the one distributed by the negotiators, reveals that the main burden for reducing the deficit has fallen on tax increases and defense cutbacks. Including income from asset sales (which, in the arcane world of federal budgeting, are labelled "negative spending"), revenue increases account for more than half of the reported deficit reduction. On the spending side, almost half of the outlay reduction is accounted for by defense programs. Entitlements and discretionary domestic spending were hardly cut at all.

> ***. . . the main burden for reducing the deficit has fallen on tax increases and defense cutbacks.***

The tax increases and defense cuts are about the only amounts in the agreement that can be taken at face value. Tougher IRS compliance might generate additional revenue, but not because of what the White House Congress do on the budget. Asset sales should properly be regarded as a means of financing the deficit; they do not reduce the government's draw on capital markets. The promised entitlement cutbacks are just that — promises grounded in flaky estimates and sometimes used to hide program expansions which compel higher spending in the future.

*(Continued on page 4)*

(BUDGET WATCH, *from page 3*)

An even more dismal appraisal of what the negotiators accomplished emerges from a comparison of the deficit reduction they agreed to and the reductions that would have been made if the Gramm-Rudman-Hollings sequestration were put into effect for the current fiscal year.

The so-called compromise shifted deficit reduction outlays to tax increases and opened the door to renewed use of gimmicks such as asset sales. Outlay reductions are only half the amount they would have been under the GRH process. Even if the agreement is fully carried out by Congress in enacting appropriations and other legislation, the deficit situation will continue to deteriorate.

**Table 2**
**Comparison of GRH Sequestration To Summit Agreement**
**FY1988**
**($billions)**

| | Sequestration | Summit Agreement |
|---|---|---|
| **Tax Increases** | $ 0.0 | $ 9.0 |
| **Outlay Reductions** | 23.0 | 11.6 |
| **Asset Sales** | 0.0 | 5.0 |

- The actual fiscal 1988 deficit will almost certainly be higher than the 1987 deficit. It might be a lot higher if the economy slows down.
- The deficit for fiscal 1989 will probably be above the GRH target; if this occurs, there might be a need to sequester funds shortly before next year's elections.
- The GRH process will have to be revised again. There is no realistic possibility of meeting the deficit targets for 1990 and beyond.
- Record-breaking deficits of $250 billion and higher cannot be ruled out if the economy goes into a tailspin.

### What Have We Learned from The Budget Summit?

All sorts of reasons have been offered for the failure of the budget summit: the impending elections; the split government which has put a Republican in the White House while giving the Democrats control of Capitol Hill; the "sacred cow" status of social security and other entitlements; the guns versus butter and the spending cuts versus tax increase battles that have raged through the 1980s. Excuses aside, the summit offers some important insights into the problems confronting the federal budget.

(1) *The budget stalemate mirrors contradictions in American public opinion.* A New York Times/CBS poll taken immediately after the summit agreement was announced reported that most Americans want a balanced budget but do not want to pay higher taxes or have the government cutback defense or social programs. This contradiction is not new, but dealing with it has been made more difficult by the relatively low growth of the past dozen years. The summit negotiators, like the American people, also tried to have it both ways, cutting the deficit without significant retrenchment in spending.

(2) *A big dent cannot be made in the deficit without making hard choices on social security and other transfers.* Entitlements comprise almost half of federal spending; add in interest charges and mandatory payments account for almost two-thirds of the total. When the negotiators took social security off the table, they eliminated any possibility of sizeable deficit reduction. Ironically, social security is perhaps the only part of the budget on the expenditure side for which a summit is necessary. Everything else can be dealt with through the regular presidential and congressional procedures.

(3) *A summit is no substitute for a workable budget process.*The budget process has been under extraordinary strain in recent years, with most of the year's work crammed into a gargantuan continuing resolution and a omnibus reconciliation bill. Compressing so many decisions into these two measures has been accompanied by a vast escalation of budgetary conflict between the two branches, and legislative gridlock in Congress. The summit was seen as a means of cutting through these conflicts; instead it escalated the political stakes and emphasized the deep divisions between Republicans and Democrats on the budget. While summitry has its place, there have to be quieter opportunities for making revenue and spending decisions through the everyday routines of the budget process.

*The deficit for fiscal 1989 will probably be above the GRH target; if this occurs, there might be a need to sequester funds shortly before next year's elections.*

(4) *The next President will have to grapple with the budget issues that the summit avoided.* It was not by accident that the summit worked out a two-year deal. Both the White House and Congress had a strong incentive to postpone tough decisions. The next President will not have it so easy. When he enters the Oval Office on January 20, 1989, he will find an envelope containing his predecessor's last will and testament. It will read, "Being of sound mind and body, I leave all my budget problems to you."

**Tax Features**

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# FEDERAL TAX POLICY MEMO

**Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy**

**JANUARY 1988**

# Tax Package Adopted; Process Sags Again

Late last month House and Senate conferees finally agreed on another patchwork tax increase incorporated as The Revenue Act of 1987 or Title X of HR 3545, the omnibus reconciliation bill. For weeks the outcome appeared inevitable, leaving only a massaging of particular provisions to fit targets predetermined by the budget "summit" of $9 billion and $14 billion in new revenues for FY1988 and FY1989, respectively.

Some of the most controversial provisions in the House or Senate bills were not adopted. The alternative minimum tax increase, the removal of the hospital insurance payroll base limit, the restriction of cafeteria plans, and most of the so-called "corporate control" items dropped out of the running. This had more to do with the time pressures on the conference and the need to concentrate on those items common to *both* plans than deliberate policy decisions.

While dodging some bullets, the corporate sector hardly escaped unscathed. Over $5 billion or 55 percent of the FY1988 overall tax increase, and $7.5 billion or 53 percent of the FY1989 increase, will come from business, mostly in bite sizes affecting individual industries or particular transactions. However, repeal of the vacation pay reserve, new funding rules for pension plans, restrictions on installment sales, and further cutback of the dividend received deduction all involve significant dollars. Some other provisions aimed at individuals and partnerships could have a negative effect on capital formation.

## The Reconciliation Muddle

This is the fourth time since 1981 that the reconciliation process under the Budget and Impoundment Act of 1974 (as amended by Gramm-Rudman-Hollings) has been used in a significant manner to raise taxes. The results, obviously, are less than optimal.

Considering both the questionable spending reductions and haphazard tax legislating in this last round, it could be argued fairly that we would have been better off just letting the Gramm-Rudman-Hollings sequester take effect. At least the latter would have forced real spending cuts. Had not the "leadership" issue — the perceived need for the Administration and Congress to prove they could do *something* with a deficit reduction label on it — intruded so pervasively, we may well have been in sequestration now.

For tax policy the reconciliation process has produced:

- Lots of confusion
- An overburden on revenue estimating
- Submergence of policy considerations.

The rush to adjourn and the decision to go for base broadening the income tax — as opposed to new excises — inevitably resulted in another round of complication for tax administrators. They will have to grapple with dozens of new provisions before the Tax Reform Act of 1986 has barely cooled. Furthermore, except for two last-minute relief actions (for mutual fund shareholders and accountants), the year-long preoccupation with deficit reduction effectively blocked critical technical corrections to the Tax Reform Act of 1986 and other widely supported adjustments, such as for allocation of R & D expenses between foreign and domestic source income.

Constant pressure to come up with doses of new revenue is straining the capacity of the Joint Committee on Taxation to make reasonable estimates of specific provisions (regardless

### The Vanished Corporate Tax Cut of 1981

**Net Effect of Major Legislation On Corporate Income Tax Receipts FY1986–1990 ($billions)**

| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| Enacted 1981–1986[1] | –14.8 | +18.5 | +19.7 | +20.6 | +24.2 |
| Revenue Act of 1987[2] | | | + 5.0 | + 7.5 | + 7.7 |
| | | | +24.7 | +28.1 | +31.9 |

[1] includes Economic Recovery Tax Act of 1981 (ERTA), Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Deficit Reduction Act of 1984 (DEFRA), Tax Reform Act of 1986 and some lesser acts.

[2] includes the following provisions as "corporate" effects: accounting provisions except dealing with partnerships; all corporate provisions under that heading; provision to modify pension funding rules; foreign tax provisions; insurance provisions; and estimated tax provisions.

Sources: Budget of the U.S. Government FY1988 and Conference Report on HR 3545.

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of one's view of the basic revenue estimating procedure used by both the Joint Committee and Treasury and its utility in measuring economic effects of multiple tax changes). Take the example of vacation pay revision. The initial revenue estimate for repealing the deduction for additions to vacation pay reserves was $235 million over three years. Affected taxpayers quickly recognized that the actual impact would be far greater – many times the initial estimate. Afterwards, the Joint Committee did raise its estimate to $3.1 billion for the three-year period and the provision was adopted.

In this case the more realistic later estimate probably helped avoid increasing taxes elsewhere and in this sense contributed to a better outcome. But if there had been no loud reaction to the original estimate, we could have ended up with both loss of the vacation pay deduction and, perhaps, the House alternative minimum tax proposal as well. Obviously, reasonable revenue estimates of multiple proposed provisions – some dealing with widely varying circumstances among taxpayers – cannot be assured. They especially cannot be assured in a pressure cooker of time constraints on the staff and legislators.

Revenue estimating has become part and parcel of the intent to inflict so much damage on – or grant so much relief to –particular economic sectors. Instead of following a policy direction to its logical revenue conclusion and perhaps then making adjustments elsewhere, we now start with a revenue "need" and try to juggle diverse provisions to fit. In the process, policy can easily get lost.

It surely did, for one example, in the case of lowering the corporate dividend received deduction from 80 percent to 70 percent where the ownership proportion is less than 20 percent. This was thrown in as a pure and simple grab from the corporate sector estimated at $1 billion over the next three years. In the House Committee report (there was no comparable Senate item), not a scintilla of policy justification was offered for a general cutback in the dividend received deduction other than a cursory statement that existing law is "too generous" for corporations that do not have sufficient ownership interest in the distributing corporation to qualify for the 100 percent deduction.

This completely ignores the double taxation of corporate income in the first place. Disregarding the Committee's points about certain dividends with non-stock characteristics, is there any real policy justification for anything *less* than a 100 percent dividend received deduction for any regular corporate investment in another corporation regardless of the ownership proportion? This latest move increases the relative tax penalty for doing business in the corporate form. It could constitute, in fact, a form of *triple* taxation when the 30 percent of dividend income subject to the penalty tax is distributed to individual shareholders.

## Looking to 1988

One of the more distressing things about the current budget/tax situation is that there is no end in sight unless we get: (a) very lucky; or (b) seized with national determination to address the deficit squarely. Neither seems likely at least until the 1988 presidential campaign is disposed of.

For FY1989, the next budget year under consideration, the revised Gramm-Rudman-Hollings procedure requires deficit reduction from FY1988 of only $8 billion to a target level of $136 billion. The politicians naturally didn't want to face a long budget hassle in the fall of an election year. With the spending reductions/tax increases under the just adopted omnibus bill – designed to knock $45 billion off the FY1989 deficit from what it otherwise would be – the deficit target would *seem* to be obtainable. But this depends on both the planned spending reductions and anticipated revenue growth being realized. If the overall economy slows significantly, so will revenue growth and both the FY1988 and FY1989 deficits could rise significantly. Most private economic forecasts suggest that revenue growth in the 1988-1989 period will be more sluggish than implied by the Administration's current economic outlook. We could find ourselves right back in the same soup next summer and fall, facing the need for another round of tax bites and spending cuts or a Gramm-Rudman-Hollings sequester.

Going into recession or even an official *forecast* of recession would short circuit the Gramm-Rudman-Hollings procedure. And, supposedly, politicians don't raise taxes in election years or recession anyway. But they did in 1982 and we can't rule it out.

Recession or not, the type of tax increase that would be considered in an election year would very likely be the same as we just experienced. Tax rate increases are surely out of the question and despite Bruce Babbitt's lonely stand, nobody else seems to be taking a new consumption tax seriously at this point. Nicking the business sector and upper income individuals would again be the path of least resistance.

If tax actions, such as under the Revenue Act of 1987 and quite possibly again in 1988, help dress up the budget temporarily, they may well be counterproductive of the central purpose of long-term deficit reduction. That is to cut back government's drag on overall savings, encourage private saving to fill investment needs and concurrently reduce our reliance on foreign borrowing. Raising taxes on business and capital appears to be a peculiar way to go about it.

* * *

Perhaps *after* the 1988 election, realization of the futility of current tax policy will sink in. And regardless of the direction of tax policy in economic terms, there simply *has* to be a better way to conduct the legislative process. Rolling all tax and spending legislation into a huge year-end ball that careens over all other concerns is making any policy judgments much harder to make and more easily frustrated.

(CONFERENCE, *from page 1*)

able to finance new capital formation. You're all familiar with the phrase 'crowding out.' That's what I'm talking about here."

### The Budget Monster

"Taming the Budget Monster" occupied the rest of the morning, with presentations by White House policy analyst Bruce Bartlett; Harvey Galper, Associate National Director for Tax Analysis, Peat Marwick Main & Co.; and Allen Schick of the University of Maryland, who is also a member of the Tax Foundation's Shadow Committee on the Federal Budget.

### The Deficit Reduction Package

Bruce Bartlett focused almost exclusively on the deficit reduction package then being negotiated by the Administration and Congress. Noting that failure to agree would intensify the impression that the President and the legislators were in a state of gridlock, Bartlett argued, "Merely reaching some kind of meaningful agreement with the Democratically controlled Congress sends an important message to the world that President Reagan and the Congress can work together to solve important national problems."

Charging that "Congress appears to be disinclined to do more than it has done to cut spending," Bartlett concluded pessimistically that "the best we can probably hope for in the near term is to keep the deficit from rising above 1987's levels."

### Taxes and the Deficit

"Where we go from here on the tax side" furnished Harvey Galper with the theme of his conference paper. "Let me begin my remarks with a bold statement," he said. "You can debate it if you want, but at least I'm convinced. The statement is this: We will not succeed in reducing the federal deficit to levels that we would all find acceptable without a significant tax increase." The tax expert from Peat Marwick Main & Co. said he was convinced of the need "to determine the amount and kind of tax increase we will be willing to accept if we are serious about making substantial inroads on the budget deficit." He proposed — "for argument's sake" — tax increases on the order of 1 % of GNP, or $50 - 55 billion, by 1990.

*(Continued on page 6)*

## THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

### "Congress Bashing"

When a pitcher throws a ball low, and slow, the only thing to do is hit it out of the park. When a public institution continually shows its worst side, it provides a field-day for cartoonists, standup comics and late night talk show hosts.

That seems to have become the status of the United States Congress whose antics would be laughable if they didn't so directly impact the fate of 242 million Americans and, ultimately, 4.9 billion human beings. Considering both the questionable spending reductions and haphazard tax legislating in this last round, it could be argued fairly that we would have been better off just letting the Grammm-Rudman-Hollings sequester take effect. And while Congress spent the entire year arguing over the budget, it failed to move at all on many pieces of vital legislation. In short, Congress is in danger of becoming a parody of itself, a guarantee of full employment for political satirists of all persuasions.

Democracy is inherently messy. It lacks the spit and polish of totalitarianism. Maybe that's why in the old war movies the Nazis always had the best uniforms and the shiniest tanks and planes, while the sloppy, disorganized GIs barely managed to muddle through to victory with their shirttails hanging out.

There are grounds for arguing that the Founding Fathers, in designing the Constitution they bequeathed to us two centuries ago, built into that unique instrument guarantees that our representative form of government would remain chaotic and bumptious. Certainly, they deliberately chose to avoid the elegant foppery of the courts of 18th century Europe. Homespun cloth and muddy boots were more the uniform of the day at the Constitutional Convention than satins and powdered wigs.

Granting that our political structures represent a triumph of the common man, one cannot help wishing that those who hold public office might be just a little less "common." We deserve better of them. They deserve better of themselves.

A number of legislators have already declared their unwillingness to seek reelection to the House or Senate. Explicitly, or between the lines, it is possible to detect that they, themselves, are fed up with the pervasive lack of respect shown toward the nation's highest legislative body. National office has not only ceased to be fulfilling — or fun. It is also in imminent danger of becoming ludicrous.

An earlier generation of Americans rescued the political process from the smoke-filled rooms and machine politics. The present generation had better find a way to rescue the politicians from themselves before lawmaking again becomes so tainted that it will be left to those considered too inept to hold down a "real" job.

### *John Wesley Hanes, Sr.*

John W. Hanes, Sr., widely known as a public official during the Roosevelt Administration and as a civic-minded corporate executive, died December 24 at the age of 95.

Mr. Hanes joined the Tax Foundation's Board of Directors in 1945, served as chairman from 1947 to 1957, and since then as Chairman of the Executive Committe and Honorary Chairman.

### *George Grayson Tyler*

George Grayson Tyler, a former head of the tax department of the law firm of Cravath, Swain & Moore and for 22 years a trustee of the Tax Foundation, died of a heart attack on January 4. He was 81 years old.

An expert in the field of corporate tax, Mr. Tyler's clients included Chemical Bank, Exxon, Time Inc. and Westinghouse.

(CONFERENCE, *from page 5*)

### Four Possible Approaches

Galper listed four possible ways to raising new revenues: broadening the tax base; raising tax rates; miscellaneous taxes, which he called "cats and dogs or odds and ends"; and introducing a new revenue source. "Various combinations of these are also possible," he added. After discussing tax options under each approach, and outlining possible alternative Republican and Democratic strategies, depending on the 1988 election results, he concluded, "I would rather see a continuing reliance on broad-based income taxes, even if we have to have higher tax rates in order to do it." He argued that it would be possible to raise "something like $30 billion from rate increases," adding that his preference was "to go even further on the income tax side, upwards of $40 - 45 billion." Galper opposed moving in the direction of a value-added tax, both because of its potential impact on the tax structure and because of "what it might also portend for future spending increases as well."

> ***On the long-term budget deficit:***
>
> ***". . . massive deficits pose two serious threats that cannot be ignored: a temptation to try to inflate our way out of the problem by monetizing the deficits. . .[and] not so dramatic . . . but just as debilitating, the drain on our supply of savings that would otherwise be available to finance new capital formation."***
>
> ***– Edgar Fiedler***

### The Budget Process

How budgets are constructed was discussed by Allen Schick in the final talk of the morning. He approached the topic from both a short-term and a longer term perspective, finding a great deal of fault with the short-term agreement then undergoing ratification. "There's less deficit reduction than if nothing happened and the automatic sequestration had taken place," he charged. He went on to point out that there is "a very good chance" that the fiscal 1988 deficit will be higher than the fiscal 1987 deficit, and "then we'll have again the problem of a reversal of expectations and disappointment."

### A Failed Summit

Schick faulted the budget summit meeting between the Administration and the Congress for failing to achieve the one thing only a summit could have achieved: "to deal with entitlements, particularly social security. . . That's what they needed a summit conference for and that's what they didn't touch." Schick also foresaw enforcing the agreement as another short-term problem.

### The Long-Term Problem

Describing the long-term consequences of budget deficits as "much more worrisome," Schick reviewed the history of the growth of public spending, linking it with a period in the nation's life when the economy was in a high-growth mode of 4 to 5 percent a year. "We learned how, through our budget procedures, to spend that 4 to 5 percent a year," he explained. Then came a situation in 1985 and 1986 when the economy was growing at 2 to 2 1/2 percent a year. Despite the record length for a peacetime expansion, "we have these massive structural deficits of about $175 billion, close to more than 4 percent of GNP. . . We didn't grow out of the deficit despite five consecutive years of growth for a very simple reason," he pointed out. "If our political budget structure is geared to grow in spending terms at 4 percent a year and the economy is only growing at 2 1/2 percent, that means a deficit." This creates a situation, he explained, where the deficit will continue to grow larger because "we have become accustomed to spending more."

### Resolving the Dilemma

"The long-term solution," Schick said, "that we must find is to reconcile the contradictions in public opinion between spending more and having a smaller government and also by reconciling the growth in government with the growth in the economy." He added that he was pessimistic about this happening, because the national expectation is for spending to continue to grow at a greater rate than the economy and because "the demographics are working against us." Schick foresaw the need for a political trade if a solution is to be achieved, a trade in which social security taxes and benefits would be adjusted downward in exchange for increases in general taxation.

### Tax Policy Post Reform

The present and future impact of the massive revisions contained in the Tax Reform Act of 1986 (TRA86) came under examination in the afternoon session of the Conference. Wilfred Tremblay, Vice President-Taxes, M.A. Hanna Company, and a member of the Tax Foundation's Advisory Council, chaired the session.

### A Positive Step

While he expressed some reservations about the Tax Reform Act of 1986, J. Roger Mentz, a tax lawyer with the Washington firm of Cadwalader, Wickersham & Taft who served in the Treasury's Office of Tax Policy as the 1986 bill was being developed, told the conference, "I think tax reform on the whole is a very major positive step for our income tax system." He singled out the two major accomplishments of the landmark legislation: "the virtual elimination of individual income tax shelters"; and the "major antipoverty program" involved in removing a number of low earners from the tax rolls or "dramatically" lowering their income taxes.

"Was it the best bill that could have possibly been conceived?" he asked. "No. But was it the best bill that the political system could have enacted? Yes." He added, "Those of you who

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are deeply involved in your corporation's tax problems or are practicing law and are working with the Tax Reform Act know that there are a lot of rough edges that have to be fixed."

Part of the fixing, Mentz described as "technical corrections," but he also emphasized "there are other maybe not-so-technical corrections that also need fixing." He emphasized strongly the need to deal with what he called "this straight-jacket of revenue constraints, Gramm-Rudman constraints."

### Pressure for Revenues

David Brockway, chairman of the Joint Committee on Taxation, followed Mentz, with a prediction that "great pressure" for more tax revenues, driven by "the enormous deficit," would likely result in base broadening. He indicated that he saw no chance for major increases in excise taxes, significant rate increases, or a value-added tax without strong presidential leadership. "Congress is not structured to go forward by itself in making those kinds of politically unpalatable changes without the administration going along with it," he noted.

> ***On the budget summit:***
> ***"To deal with entitlements, particluarly social security – that's what they needed a conference for and that's what they didn't touch."***
> ***– Allen Schick***

Focusing on the problems that so many tax changes create for the professional tax staff of the Congress, Brockway concluded, "It is a very difficult environment for us, as it is for the taxpayers, when we have tax policy driving changes in the base, major changes in the base, every year. As I say, I expect that to be what we're facing for the next few years."

### Special Recognition

A highlight of the afternoon was presentation of special public service acknowledgments to both the Joint Committee on Taxation and the Office of Tax Policy of the Department of the Treasury.

### Covering Tax Policy

Jeffrey H. Birnbaum, chief congressional correspondent for the Wall Street Journal, was featured speaker at the conference luncheon, which was chaired by Tax Foundation Trustee M. Alanson Johnson, II, Treasurer of the P.H. Glatfelter Company. Birnbaum discussed the evolution of the 1986 tax bill, the history of which he coauthored with Alan Murray in his book *Showdown at Gucci Gulch*.

"I believe tax reform passed," Birnbaum said, "not because anyone really wanted it — indeed, it was the bill that nobody wanted — it succeeded because so few people were willing to kill it once it got rolling. Put another way, no one wanted the dog to die on his doorstep."

Birnbaum said that "even the men who shepherded the bill forward — Treasury Secretary James Baker, Senate Finance chairman, at the time, Bob Packwood, and House Ways and Means Chairman Dan Rostenkowski — approached the task reluctantly. The only constituency for reform was the great mass of voters who paid their taxes each year without the benefits of shelters and tax gimmicks, and even they were skeptical."

### Public Service Award

Senator Daniel Patrick Moynihan, senior Senator from New York, was honored at the Foundation's 50th Anniversary dinner that evening. Introducing Moynihan, Hans W. Wanders, President of The Wachovia Corporation and Chairman of the Foundation, noted "In considering who should receive the Tax Foundation's Distinguished Public Service Award on the occasion of our 50th anniversary, the trustees were especially desirous of honoring an individual whose public career mirrors the ideal expressed in the Foundation's motto — 'Toward Better Government Through Citizen Understanding.' And who would be more appropriately recognized than the distinguished senior Senator from the State of New York? And how appropriate it is that the Tax Foundation, which was founded in New York, recognizes on this occasion an individual who has served his state so well."

### A Real Public Service

"You really are a public service," Moynihan replied, "at a time when, by your own accounts, it would be a very misguided public person indeed who placed any high level of confidence in the official data of the United States. . .

"There is one standard of disinterested objectivity which is maintained and which is accessible to laymen such as I, and those are the reports of the Tax Foundation. We read them, and we trust them. It takes half a century to gain that kind of trust, and it should be treasured."

The bulk of the Senator's address was devoted to the "how our public finances have come to such present desolation . . . the origins of our present crisis." He attributed this crisis to a failure to link the enormous tax cuts of the early Reagan years with corresponding spending restraint.

> ***On tax planning:***
> ***"It is a very difficult environment for . . . taxpayers, when we have tax policy driving major changes in the base every year."***
> ***– David Brockway***

"In 1981 the United States was not about to be driven into the sea," he noted, "but it could happen now, if we think it's happening. We could come upon a political Dunkirk. But need we?"

The Senator argued that it is just as possible to solve the trade and budget deficits as it was to restructure the funding of the social security system funding in the early 1980s. "It took us three years to decide to do something to fix it," he pointed out, "but when we did. . . it took. . . exactly 12 days to do it. . . These things are doable when people want them done."

(TAX LEGISLATION, *from page 3*)

taxpayers. The measures passed included a major change in depreciation allowances, extension of IRAs to everyone, bracket indexing, and the general individual rate cuts.

## Revenue Raisers

However, such large revenue reductions as envisioned by the 1964 act and particularly ERTA would not be left to run their course. Ironically, the two legislative acts *increasing* total Federal revenues as a percentage of GNP directly followed the two largest revenue reduction acts. Both the Revenue and Expenditure Control Act of 1968 and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) increased total Federal tax revenue well above 1 % of GNP, diminishing the revenue reductions promised by the acts which preceded them in 1964 and 1981. It may be said, "what the Federal government giveth . . . the Federal government taketh away." In fact, the three major acts enacted after ERTA in 1981 have been major revenue raisers (excluding tax provisions for fiscal 1988). TEFRA repealed more than half of the benefits for corporations, the Social Security Amendments of 1983 raised payroll taxes and subjected social security benefits to the income tax for the first time, and the Deficit Reduction Act of 1984 (DEFRA) further reduced corporate depreciation allowances. In fact, the "revenue neutral" Tax Reform Act of 1986 raises an estimated $18.6 billion in revenues in 1987, disproportionately increasing corporate tax revenues by $28.2 billion while reducing individuals' taxes by $10.6 billion. The so-called "great corporate giveaway" of 1981 was taken away before its incentives could ever be fully realized. The dominant motive behind most enacted tax legislation after ERTA was purely and simply to raise dollars.

## Seesaw Effect

The net effect of all tax acts since 1981 is revealed in the Exhibit presented in Table 1. The original estimated reductions under ERTA which averaged $260 billion and 5.5% of GNP during each year between 1986-1990 translate into only $149 billion and 3.1% of GNP for the same period by 1986. Further examination of the net revenue effect since ERTA reveals an astonishing reversal in the corporate tax cuts. In 1981, ERTA promised estimated corporate tax reductions averaging $51 billion in years 1987-1989; however, by 1986 subsequent tax acts parlayed this reduction into an estimated $20 billion revenue increase in each of the same years. In the final analysis, 43% of the total tax reductions granted by ERTA for the period of 1986-1990 has thus far been eroded by subsequent tax acts.

The history of major tax legislation since 1964 represents a seesaw of revenue decreases and increases without any apparent consistency from a Federal tax policy viewpoint. Unfortunately, this history seems bound to continue. Congress is now facing the real dilemma of reducing the huge deficits projected well into the future while trying to encourage savings and economic growth. Revenue increases will certainly be part of the picture, and continued tinkering with the tax system as illustrated by the pattern that has prevailed since 1964 seems inevitable.

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# TAX·FEATURES

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## Address Budget and Deficit Issues, Shadow Committee Urges Candidates

Astonishment at the way presidential candidates have dodged the budget and deficit issues is the principal reaction of the Tax Foundation's Shadow Committee on the Federal Budget to the election debate now in progress. "The wishful thinking that pervades the campaign may severely constrict the budgetary options available to the next President," the Committee warns in its February 26 report.

### Delaying Hard Choices

The Committee faults the succumbing to election year pressures and the churning out of optimistic deficit projections that even slight underperformance by the economy may subvert. "With the structural deficit hovering around the $150 billion mark, it will not take much of a shortfall in economic performance to push the deficit to new record levels," the report observes.

In essence, official Washington has "offloaded the task of recommending a package of tax increases and/or spending cuts onto an Economic Commission which is scheduled to report shortly after the new President takes office," the Committee says. Meanwhile, the optimistic forecasts contained in the President's Budget for fiscal 1989 have been accepted by all parties in the fiscal debate as a way of postponing the hard choices until after the November elections.

### Little Elbow Room

One-time factors such as the 1986 tax bill, asset sales, and rescheduling of payments accounted for about half of the deficit reduction in fiscal 1988. Unemployment probably cannot go much lower. There is little room for further cuts in defense spending, paring of grants to states and localities, or reductions in the operating budgets of Federal agencies, the report notes, pointing out that mandated payments for individuals, together with interest charges, now comprise more than 60 percent of total outlays — a share which is expected to increase in the years ahead.

Compounding this shrinkage in areas where budget cuts have traditionally been found is the illusory impact of large surpluses in

(Continued on page 5)

## *1986 Property Tax Growth Outpaces Other Taxes*

State and local property tax revenues increased by a hefty 7.7 percent in fiscal year 1986, outpacing the 6.2 percent increase in nonproperty taxes. Property tax payments to state and local governments totaled $111.7 billion in 1986, almost double the $57 billion collected ten years earlier. Fiscal 1986 revenues topped 1985 by $7.9 billion and accounted for 29.9 percent of total state and local tax revenues.

The 7.7 percent growth in property taxes in 1986 exceeded the growth rate in sales taxes (6.9 percent), individual income taxes (6.2 percent) and corporate income tax revenue at 4.1 percent. Over the past decade property tax growth has averaged 7 percent annually.

### Major Source of Local Revenues

Property tax remains the leading tax revenue source for local governments providing 74 percent of the total in 1986. Local property tax revenue in 1986 totaled $107.4 billion, up $7.6 billion from 1985. Although most states impose some type of property tax, the levies generally apply to a narrow base and furnish under 2 percent of total state monies.

### Slower Growth Per Capita

While total property taxes have risen by nearly 100 percent over the past decade from $57 billion to $111.7 billion, the percentage growth in per capita property taxes has been less — 74 percent, from $266 in 1976 to $463 in 1986.

Moreover, when related to personal income, property taxes have actually declined — from $45 per $1,000 of personal income 10 years ago to $34 in 1986, or 24 percent.

### Per Capita Trends

On a per capita basis, Wyoming (with collections of $1,173) and Alaska ($1,084) far outdistanced any other state. In third position was the

(Continued on page 8; complete table on page 6)

# New Study Hits U.S. Taxation of Multinationals

U.S. multinationals are operating under a significant disadvantage in world markets when compared to competing multinationals of other key international trading nations because of burdensome U.S. tax laws, according to a recent study entitled "The Competitive Burden: Tax Treatment of U.S. Multinationals." The study, believed to be the first to actually compare the competitive effects of tax laws in several countries, was conducted by Arthur Young, the international accounting and consulting firm, and published by the Tax Foundation.

In comparing the tax policies of the United States with those of The Netherlands, Japan and Germany, the study found that U.S. multinationals face a severe competitive disadvantage in world markets because of Federal tax policy enacted over the past 20 years, including the 1986 Tax Reform Act.

In announcing the findings at a press conference in New York City on January 19, William Gladstone, chairman of Arthur Young, said, "Tax law always has been a powerful economic policy-making instrument. The Netherlands, Germany and Japan have adopted tax policies that, to varying degrees, encourage firms to do business overseas. Essentially, the United States has adopted exactly the opposite policy."

Robert C. Brown, president of the Tax Foundation, commented, "At a time when U.S. business is just beginning to show signs of increased export activity, the Tax Reform Act of 1986, on top of prior tax restrictions, delivers a discouraging blow to our ability to compete globally. And this, in turn, will have a negative effect on domestic investment and job opportunities."

According to Ray Haas, the author of the study and an international tax partner of Arthur Young, U.S. tax policy hamstrings U.S. multinationals primarily in three areas: rules relating to exemption or deferral of home

(Continued on page 8)

# FY'88 Tax Burden Up $55 Billion; Increase Falls on Corporations

Federal taxes will climb 6.6 percent in the 1988 fiscal year, hitting $885.1 billion, compared with $830.5 billion in FY1987, according to Tax Foundation analysis of the projections in the budget the President sent to Congress last month. For individual taxpayers this represents only a 0.2 percent tax increase over last year. For corporations, the news is much less pleasant. They will take a $105.6 billion hit, a 26 percent jump over fiscal 1987 levels.

## Total Tax Burdens

Burdens, predictably, are heaviest in the most populous states. The top ten paying states are: ($Millions)

| | |
|---|---|
| California | $ 111,631 |
| New York | 77,480 |
| Texas | 58,648 |
| Illinois | 46,638 |
| Florida | 43,585 |
| Pennsylvania | 42,622 |
| New Jersey | 39,083 |
| Ohio | 37,644 |
| Michigan | 34,996 |
| Massachusetts | 26,456 |

These "big ten" states will send Uncle Sam $518.8 billion in FY88, 59 percent of all Federal taxes to be collected.

At the lower end of the scale, tax burdens will be lightest on the following nine states, plus the District of Columbia: ($Millions)

| | |
|---|---|
| Maine | $ 3,494 |
| District of Columbia | 3,155 |
| Delaware | 2,648 |
| Idaho | 2,632 |
| Alaska | 2,560 |
| Montana | 2,316 |
| N. Dakota | 2,019 |
| S. Dakota | 1,872 |
| Vermont | 1,710 |
| Wyoming | 1,642 |

These bottom 10 states will pay only 2.7 percent of the total Federal tax burden, a total of $24.0 billion.

## Per Capita Tax Burdens

When total Federal taxes paid are ranked according to the per capita burden in a given state, Tax Foundation researchers note an increase of $189 over 1987 amounts. On average, the national per capita Federal tax burden will hit $3,603 in FY88. Individuals carry the largest burden in these ten states: ($Thousands)

| | |
|---|---|
| Connecticut | $ 5,410 |
| New Jersey | 5,075 |
| District of Columbia | 5,057 |
| Massachusetts | 4,510 |
| Alaska | 4,430 |
| New York | 4,339 |
| Maryland | 4,303 |
| Delaware | 4,106 |
| New Hampshire | 4,071 |
| Illinois | 4,020 |

The average Federal tax burden per capita for citizens in the top ten states is $4,532. Lowest burdens, an average of $2,535, are borne by taxpayers in the following ten states: ($Thousands)

| | |
|---|---|
| New Mexico | $ 2,664 |
| Alabama | 2,657 |
| S. Dakota | 2,621 |
| Kentucky | 2,591 |
| Idaho | 2,581 |
| Arkansas | 2,536 |
| West Virginia | 2,487 |
| Utah | 2,440 |
| Mississippi | 2,153 |

Tax Foundation researchers point out that citizens in the top ten states will pay an average per capita tax burden that is $1,997 higher than citizens in the lowest per capita states.

*Note: "Memorandum on the Allocation of the Federal Tax Burden by State, Fiscal Years 1987–89," and "Federal Tax Burdens in States and Metropolitan Areas," which provide a 10-year tax burden history and explain the methodology of the study, are available from the Tax Foundation.*

*(Complete table on page 7)*

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**Budget Watch** By Allen Schick

# Making Elderly Americans Dependent on Government Assistance

Judging from its policies, the Federal government prefers that older persons be dependent on it for assistance rather than be able to finance their own needs. This attitude is reflected in the taxes levied on the elderly and in the benefits provided to them. Whatever its objectives, this policy has two adverse consequences: (1) the aged must rely on Washington for an increasing portion of their income; and (2) the Federal government is burdened by soaring costs of assistance to the elderly.

### Taxing the Elderly

Reductions in marginal income tax rates has been one of the foremost accomplishments of the 1980s. At the start of the decade, these rates were as high as 50 percent on "earned" income and 70 percent on investment income. Marginal rates were lowered by legislation enacted in 1981 and 1986. The highest nominal rate in tax year '88 will be only 28 percent, though many upper middle class taxpayers will pay a top marginal rate of 33 percent.

But while overall tax rates have been lowered, Americans above the age of 65 can bear extraordinarily high tax burdens. Many now have marginal rates above the 1980 levels, making them the only major group facing this predicament. Three tax provisions—one predating the 1980s and two recent developments—account for this situation. Moreover, pending legislation that is likely to be enacted before this year's election will raise the marginal burden on the elderly even higher.

> *. . . the aged must rely on Washington for an increasing portion of their income . . .*

- Workers between the ages of 65 and 69 face loss of social security benefits if they earn more than $8,400 a year. Their benefits are reduced by $1 for every $2 earned above that amount. No benefits are provided to those who make above $20,000. This penalty is equivalent to a 50 percent tax rate, far above the rate levied on the wealthiest taxpayers. On average, elderly workers risk losing thousands in annual social security payments.

> *. . . while overall tax rates have been lowered, Americans above the age of 65 continue to bear extraordinarily high tax burdens.*

- Since 1983, half of the social security benefits have been treated as taxable income for single taxpayers making more than $25,000 a year and for households with income in excess of $32,000. These income levels have not been indexed; as a result, the number of elderly who have their benefits taxed will steadily rise in the years ahead. It should be noted that proposals in Congress would tax all social security payments for persons above these income brackets.
- The monthly Part B medicare premium (for supplementary medical insurance) has nearly tripled in this decade from $8.70 in 1980 to $24.80 in 1988. This growth rate has been more than three times the increase in social security benefits. A retired person who earned the minimum wage while working now uses 5.3 percent of his social security check for the Part B premium, up from 2.9 percent at the start of the decade.
- Pending legislation to expand medicare coverage would increase the monthly premium and also establish an additional income-based premium. By 1992, when the legislation would be fully effective, the House-passed bill would raise premiums for all elderly persons by $5.70 a month; the Senate-passed version would raise the payments by $9.70 a month. Each version would also impose a graduated premium based on income that would be as much as $1,000 a year for persons of relatively modest means by 1992. The House would link this premium to adjusted gross income; the Senate would impose a surtax amounting to about 10 percent on elderly taxpayers. The House measure has two features which would make it more burdensome than the Senate bill. First, the graduated premium would not be deductible as a medical expense; second, medicare participants would not be able to avoid this additional tax by withdrawing from the Part B program.

These four factors add up to a heavy burden on many elderly Americans. The net effect is to encourage them to be dependent. If they work after retirement, they lose social security benefits and pay higher medical premiums; if they save before retirement, they pay the higher premiums and are taxed on half their social security payments. Although only a minority of the elderly are in

> *Workers between the ages of 65 and 69 have their benefits . . . reduced by $1 for every $2 earned above $8,400 . . . equivalent to a 50 percent tax rate, far above the rate levied on the wealthiest taxpayers.*

(Continued on page 4)

(BUDGET WATCH, *from page 3*)

this particular predicament, this is because so many of them have become dependent on the government for financial assistance.

### The Burden on Government

Taxes are only one side of the financial relationship between older Americans and government. The other side consists of the benefits paid for by public expenditure. Over the years, an increasing share of the Federal budget has been allocated to programs directly serving the elderly. The portion of Federal outlays going to these programs has nearly doubled from 15 percent in 1960 to almost 30 percent today. The share of domestic spending earmarked to the elderly is approaching the 50 percent mark. The accompanying table identifies the direct assistance provided to the elderly. It should not be surprising that the largest share goes to social security. All told, this and other retirement benefits take two-thirds of the aid to elderly persons. A little more than one quarter goes for financing or providing health care. Additional amounts finance housing, social services, and other programs.

#### Federal Outlays Directly Benefitting the Elderly

**Fiscal Year 1986**

**($Billions)**

| | | |
|---|---|---|
| Social security | $ 146.2 | |
| Supplemental Security Income | 3.7 | |
| Veterans compensation-pensions | 6.1 | |
| Other retired & disabled | 25.9 | |
| **Total retirement/disability** | | **$ 181.9** |
| Medicare | 64.4 | |
| Medicaid | 8.9 | |
| Other health programs | 4.7 | |
| **Total health** | | **78.0** |
| Housing programs | 5.4 | |
| Social services | 1.8 | |
| Low-income food & energy assistance | 1.2 | |
| Miscellaneous | 1.2 | |
| **Total other programs** | | **9.6** |
| **Total direct assistance to elderly** | | **$ 269.5** |

Source: US Office of Management and Budget

> *The portion of Federal outlays going to programs [for the elderly] has nearly doubled from 15 percent in 1960 to almost 30 percent today.*

The share of the budget going to the elderly will rise in coming decades even if benefits are not improved. The linkage of social security payments to wages and prices will add to budget outlays, as will the growing number of elderly Americans. Current projections are that nominal expenditures will rise to $1.8 trillion a year by 2020; in constant (1987) dollars they will reach almost $500 billion, more than double current levels. Additional pressure will come from escalating health costs. Since Medicare and Medicaid were established in 1965, these costs have persistently increased faster than the overall inflation rate. With the prospective expansion of medicare coverage, Federal outlays for this program will become an even more prominent part of the budget.

### Growing Old and Dependent

Higher taxes and higher benefits translate into growing dependency. According to the Department of Health and Human Services, social security has become the leading source of income for the elderly while earnings have declined in importance. Social security now provides 32 percent of the income for families headed by a person 65 or older, compared to only 23 percent in the late 1960s. During the past two decades, however, earnings have dropped from almost half of the income of these families to less than 30 percent.

The reliability of these figures is problematic because there is reason to believe that many elderly participate in the underground economy, receiving cash or other unreported income to escape the tax burdens discussed earlier. Other elderly forgo work opportunities in order to protect their benefits or to ease their tax burdens.

Thus far, dependency has been a good deal for most elderly. Recent retirees can expect to receive social security benefits far greater than the investment yield of the taxes they paid while working plus the employer contributions. Future recipients will get a worse deal from social security; many may not recover the value of the taxes paid plus interest.

Unless the government alters its policy, the outlook for the elderly will become increasingly bleak in the next century. Those who save for old age will be penalized, as will persons who continue working after reaching retirement age. Those who opt for dependency will find fewer taxpayers contributing to their support, as the ratio of workers to social security recipients drops from 3.3 to 1 in 1987 to a projected 1.9 to 1 by the year 2030. About that time, the social security trust fund will begin paying hundreds of billions of dollars each year in excess of income until it is depleted by the middle of the 21st century. No one can foresee what will happen if and when that occurs, but one thing is certain. Tens of millions of older Americans will learn that dependency is not such a good deal after all.

> *. . . elderly forgo work opportunities in order to protect their benefits or to ease their tax burdens.*

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

FEBRUARY/MARCH 1988

# Corporate Tax Burdens

With the approach of the 1988 Presidential election, we can expect some familiar refrains about taxes and the corporate sector. We will hear again about the great corporate "giveaway" of 1981 and how so many large profitable corporations are getting away with little or no income tax liability. Stale as these themes are, they have been repeated so often they take on a life of their own despite convincing evidence to the contrary.

First, there was a significant corporate tax cut enacted under the Economic Recovery Tax Act of 1981 (ERTA). *If* it had been allowed to take effect fully, it would have substantially reduced overall corporate income tax liabilities in the 1980s. But that didn't happen. Instead there were contravening major tax bills starting with TEFRA in 1982 and culminating with the Tax Reform Act of 1986 which obliterated the capital recovery and business tax relief of 1981 and, instead, piled on significant *net* increases in corporate tax liabilities after fiscal 1986. More recently further increases in corporate income taxes have occurred as a result of the Omnibus Budget Reconciliation Act of 1987 and the Continuing Resolution for 1988. This is shown in Table I comparing the effect of major enacted legislation in the 1981–1987 period on individual and corporate income taxes currently and projected through 1991. Individuals did experience marked income tax reductions for the period but the corporate sector was another story.

## Corporate Share of Income Taxes

What about the corporate "share" of the income tax burden? Over the long term it has shrunk as a share of total income taxes, but with some special factors affecting the trend.

As Table II indicates, there was a precipitous dropoff in corporate income tax receipts, both absolutely and as a percentage of total income taxes in fiscal 1982 and 1983. Corporate receipts fluctuate more widely than individual receipts anyway, and the severe recession of 1981-1982 had its maximum impact on revenues in fiscal 1982 and 1983. This was also the period when the Accelerated Cost Recovery System (ACRS) first took hold. More rapid depreciation, of course, helped depress tax collections initially, although this would tend to be made up in later years.

**Table I**
**Effect of Major Legislation, Enacted 1981–1987, on Individual and Corporate Income Tax Receipts**
**Fiscal Years 1987–1991**
**($Billions)**

| Income Tax | 1987 | 1988 | 1989 | 1990 | 1991 | 1986–1991 |
|---|---|---|---|---|---|---|
| Individual | -158.7 | -193.1 | -224.8 | -250.2 | -278.3 | -1,239.5 |
| Corporate | +9.7 | +24.2 | +26.8 | +33.1 | +41.0 | +159.6 |

Source: Budget of the U.S. Government, FY 1989

In the last four fiscal years, corporate income tax receipts increased sharply, shooting to a record $84 billion in fiscal 1987 and to an estimated $106 billion in fiscal 1988. The revenue recovery has coincided with better business conditions and, of course, the implementation of the 1982, 1984, and 1986 tax bills.

Critical factors in the balance of corporate versus individual taxes are both the level of corporate profits and their share of the national income. The trend in corporate profits as a percentage of national income has been irregularly downward since the 1950s. In fact, the downtrend has closely paralleled that of corporate tax receipts as a percent of total income taxes through 1986. This alone explains much of the long term decline in the proportion of corporate income taxes.

**Table II**
**Federal Corporate Income Tax Receipts**
**Selected Fiscal Years, 1950–1988**

| Year | $Billions | % of Total Income Tax Receipts | Year | $Billions | % of Total Income Tax Receipts |
|---|---|---|---|---|---|
| 1950 | $ 10.4 | 39.9% | 1977 | $ 54.9 | 25.8% |
| 1955 | 17.9 | 38.3 | 1978 | 60.0 | 24.9 |
| 1960 | 21.5 | 34.6 | 1979 | 65.7 | 23.2 |
| 1965 | 25.5 | 34.3 | 1980 | 64.6 | 20.9 |
| 1970 | 32.8 | 26.6 | 1981 | 61.1 | 17.6 |
| 1971 | 26.8 | 23.7 | 1982 | 49.2 | 14.2 |
| 1972 | 32.2 | 25.3 | 1983 | 37.0 | 11.4 |
| 1973 | 36.2 | 25.9 | 1984 | 56.9 | 16.1 |
| 1974 | 38.6 | 24.5 | 1985 | 61.3 | 15.5 |
| 1975 | 40.6 | 24.9 | 1986 | 63.1 | 15.3 |
| 1976 | 41.4 | 23.9 | 1987 | 83.9 | 17.6 |
|  |  |  | 1988(e) | 105.6 | 21.2 |

Source: Economic Reports of The President.

## Effective Rates of Tax

What about reports of low or negative rates of tax for specific corporations or industry sectors? The measurement of effective rates of corporate taxation can involve controversial issues. Some reports showing low effective rates for corporations with "economic income" ran roughshod over the measurement problems. But whatever the circumstances of individual firms, the effective rate of the Federal corporate income tax for all corporations is running about the same level as the early 1970s.

Federal income taxes are only part of the picture. Table III illustrates the overall effective rate of federal corporate income tax and rates when that tax is combined with state/local corporate income taxes and corporate payroll taxes. It is true that such

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payments can be deducted for federal corporate income tax purposes, but they are a very substantial burden nonetheless.

For comparability, corporate tax accruals net of Federal Reserve earnings are used instead of actual tax receipts. Given today's full acceleration of corporate tax payments, the accruals figures conceptually are very close to tax payments.

While Federal corporate income taxes have risen almost 70 percent in the last decade, state/local corporate income taxes have increased 139 percent for the decade and in 1987 totaled a 30 percentof the federal levy. The combined federal and state/local corporate income tax rate has risen significantly since 1979, surpassing the level of the early 1970s.

The largest element of the business tax burden, however, is now the payroll tax sector, particularly for federal social security and hospital insurance but also for state unemployment insurance and other social insurance funds. These taxes are not imposed on net income, and some economists argue that even the employer share of payroll taxes is borne by employees in lower-than-otherwise compensation. But payroll taxes are a cost of doing business and, particularly in labor-intensive industries, constitute a very large burden. Where labor is relatively scarce and/or subject to rigidities in compensation, that burden may have been absorbed by the employer.

The corporate share of payroll taxes has outstripped corporate income taxes and now runs about $122 billion. When the corporate share of payroll taxes is combined with corporate income taxes, it reached an amount equivalent to 94 percent of corporate profits in 1987.

Unfortunately, most discussion of corporate tax burdens has been based on political perceptions rather than economic reality. The ultimate burden or incidence of corporate taxes is always borne by people, not inanimate corporate structures. Investors, workers, or consumers will bear the burden, depending on the economic circumstances of the industry. Because the precise proportions are unknown and the process is obscured from public view, the corporate income tax is a hidden tax and, as such, always more susceptible to political manipulation.

As long as Congress and the Administration insist on revenue counting and estimating procedures showing "individual effects" and "corporate effects," we are forced to go along with the half-truth of the corporate tax burden as an entity in itself. But however defined, it is obvious that that burden is large and growing.

## Table III
## Total Before-Tax Corporate Profits
### Selected Years, 1950-1987

| Year | $Billions | % of Total National Income | Year | $Billions | % of Total National Income |
|---|---|---|---|---|---|
| 1950 | $ 42.9 | 18.0 | 1977 | $ 200.4 | 12.4 |
| 1955 | 49.2 | 14.6 | 1978 | 233.5 | 12.7 |
| 1960 | 49.9 | 11.7 | 1979 | 257.2 | 12.6 |
| 1965 | 77.4 | 13.2 | 1980 | 237.1 | 10.8 |
| 1970 | 76.0 | 9.1 | 1981 | 226.5 | 9.3 |
| 1971 | 87.3 | 9.7 | 1982 | 169.6 | 6.7 |
| 1972 | 101.5 | 10.2 | 1983 | 207.6 | 7.6 |
| 1973 | 127.2 | 11.3 | 1984 | 240.0 | 7.9 |
| 1974 | 138.9 | 11.5 | 1985 | 224.8 | 7.0 |
| 1975 | 134.8 | 10.4 | 1986 | 231.9 | 6.8 |
| 1976 | 170.3 | 11.8 | 1987 | 275.7 | 7.6 |

Source: Department of Commerce, Bureau of Economic Analysis.

## Table IV
## Federal and State/Local Corporate Income Taxes and Corporate Payroll Taxes
### National Income Accounts Series
### (1970–1987)

(Dollar Figures in Billions)

| Year | A<br>Corporate Profits Net of Federal Reserve Earnings | B<br>Federal Corporate Income Tax Accruals | C<br>Effective Rate of Federal Tax (B/A) | D<br>State/Local Corporate Income Tax Accruals | E<br>Effective Rate of Federal and State/Local Tax (B+D/A) | F<br>Corporate Payroll Taxes[1] | G<br>Income and Payroll Taxes as % of Corp. Profits (B+D+F/A) |
|---|---|---|---|---|---|---|---|
| 1970[2] | $ 72.4 | $ 27.1 | 37.4% | $ 3.7 | 42.5% | — | — |
| 1971 | 84.0 | 30.1 | 35.8 | 4.3 | 41.0 | — | — |
| 1972 | 98.1 | 33.4 | 34.0 | 5.3 | 39.4 | $ 22.7 | 62.6% |
| 1973 | 122.7 | 39.0 | 31.8 | 6.0 | 36.7 | 29.5 | 60.7 |
| 1974 | 133.2 | 39.5 | 29.7 | 6.7 | 34.7 | 33.2 | 59.6 |
| 1975 | 129.1 | 38.2 | 29.6 | 7.3 | 35.2 | 33.6 | 61.3 |
| 1976 | 164.3 | 48.7 | 29.6 | 9.6 | 35.5 | 39.8 | 59.7 |
| 1977 | 194.2 | 55.7 | 28.7 | 11.4 | 34.6 | 45.4 | 57.9 |
| 1978 | 225.8 | 64.4 | 28.5 | 12.1 | 33.9 | 53.7 | 57.7 |
| 1979 | 247.6 | 65.1 | 26.3 | 13.6 | 31.8 | 62.2 | 56.9 |
| 1980 | 225.2 | 58.6 | 26.0 | 14.5 | 32.5 | 66.6 | 62.0 |
| 1981 | 212.0 | 51.7 | 24.4 | 15.4 | 31.7 | 77.6 | 68.3 |
| 1982 | 154.2 | 33.8 | 21.9 | 14.0 | 31.0 | 81.7 | 84.0 |
| 1983 | 192.8 | 47.1 | 24.4 | 15.9 | 32.7 | 89.0 | 78.8 |
| 1984 | 223.3 | 59.1 | 26.5 | 18.7 | 34.8 | 104.4 | 81.6 |
| 1985 | 208.0 | 58.3 | 28.0 | 20.6 | 37.9 | 110.4 | 91.0 |
| 1986 | 215.9 | 65.9 | 30.5 | 21.3 | 40.4 | 115.6 | 93.9 |
| 1987(e) | 259.7 | 93.8 | 36.1 | 27.2 | 46.6 | 121.8 | 93.5 |

[1] Includes corporate employer share of OASDHI, state unemployment insurance tax, federal unemployment tax, railroad unemployment insurance and retirement, and workers' compensation.

[2] Includes some effect from Vietnam period surcharge.

Sources: Economic Reports of the President, various years, and unpublished statistics of the Department of Commerce, Bureau of Economic Analysis.

(SHADOW COMMITTEE, *from page 1*)

the Social Security Trust Funds on Federal Budget totals — illusory, because the present buildup will be dissipated in less than a decade when the baby-boom generation begins to retire around 2020. In addition, new increases in Federal spending on space exploration, education, and science research may be just the leading edge of a wave of demands for hikes in spending for child care, housing, and other domestic programs.

### Ignoring the Issue

Hence, the Shadow Budget Committee's chagrin over the absence of fiscal policy in the presidential debates. Hence, the Committee's warning, "The wishful thinking that pervades the campaign may severely constrict the budgetary options available to the next President. The Shadow Committee believes that parties and their candidates must play an active role in educating the American people about the need to pay for the things they want. If they fail to do so, the United States will enter the 21st century burdened by the deficits of escapist budgets."

* * *

The Shadow Committee on the Federal Budget is a citizens' watchdog group acting under the auspices of the Tax Foundation. Members of the Shadow Budget Committee are: The Honorable Harry F. Byrd, Jr.; W. Bowman Cutter, Partner, Coopers & Lybrand; Paul H. O'Neill, Chairman and Chief Executive Officer, Alcoa; Rudolph Penner of the Urban Institute, and Dr. Allen Schick of the School of Public Affairs, University of Maryland.

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## THE FRONT BURNER

**By Robert C. Brown**
**President, Tax Foundation**

### "Teamwork"

Washington finally has a winning team. It won't be found on Capitol Hill or in the White House, but at the far end of East Capitol Street, where RFK Stadium is located. How the Washington Redskins defied the oddsmakers and smashed the Denver Broncos to win a huge upset victory in Superbowl XXII contrasts sharply with the way power politics usually works in our nation's capital. Late in the first quarter, Redskin quarterback Doug Williams went down with what looked like a game-ending injury. After missing two plays, Williams returned to the game, played hurt, and produced a record-breaking second quarter and, ultimately, victory.

"Toward the end of the second quarter, I was in tremendous pain." he later told a packed house at Howard University. "I asked the offensive line to just give me a little more time. They told me, 'Don't worry, Doug.' Then the receivers and the defense did what they had to do.

"I'm standing here today, but I am not standing alone."

Courage, humility, and cooperation marked the Redskin triumph. These are rare virtues anywhere. In the world of elected officialdom, particularly in the early days of a presidential and congressional election year, they are virtually nonexistent.

How many politicians will play hurt — especially if the hurt is likely to occur at the ballot box or in the campaign war chest?

While self-deprecation is usually paid lip service on appropriate ceremonial occasions, does any politician in Washington truly believe he can't go it alone? Yet, not standing alone was the key to Superbowl XXII — again, in sharp contrast to Washington politics, where colossal egos clash in arguably splendid isolation.

Even if a sincere request for help were forthcoming in this town, what cooperation could be expected? Washington is legendary for the intensity of its political infighting. The shortest path to power is widely perceived to be up someone's back.

Competition is fine. On one level, that's what superbowls — and politics — are all about. Teamwork doesn't exclude going all out to make the starting lineup. However, what teamwork does call for — and where official Washington has fallen woefully short in recent years — is an awareness that, on game day, we're all part of a team. If the team loses, all lose.

The on-going budget fiasco is one major area where we are losing and losing big. Events are already confirming the skepticism voiced last fall by the Tax Foundation's Shadow Committee on the Federal Budget. We haven't a chance in a million of hitting FY88 deficit reduction targets. Of course, the Washington power-brokers and pundits have their answers ready. The October 19th market collapse and a slowing economy this year have become scapegoats for the shortfall. Few, if any, will concede the possibility that the market and the economy are simply reacting to the national government's woeful performance on tax and fiscal policy.

Official Washington needs to learn what all championship teams learn sooner or later: Competition may get you to the Big Game. But cooperation wins it. That's the reason we are still losing — and losing big — in the battle of the deficits. In the battle of the budget, there are no champions anywhere along Pennsylvania Avenue.

(PROPERTY TAXES, *from page 1*)

## Property Tax Collections by State, Per Capita and Per $1,000 of Personal Income

### Fiscal Years 1976 and 1986

| | Per Capita Property Tax | | | | Property Tax Per $1,000 of Personal Income | | | |
|---|---|---|---|---|---|---|---|---|
| | Amount | | Percent Change | Rank 1986 | Amount | | Percent Change | Rank 1986 |
| State | 1976 | 1986 | | | 1976 | 1986 | | |
| Total | $ 266 | $ 463 | 74.1% | — | $ 45 | $ 34 | -24.4% | — |
| Alabama | 57 | 118 | 107.0 | 51 | 13 | 11 | -15.4 | 51 |
| Alaska | 1,048 | 1,084 | 3.4 | 2 | 120 | 61 | -49.2 | 2 |
| Arizona | 282 | 422 | 49.6 | 27 | 54 | 34 | -37.0 | 25 |
| Arkansas | 101 | 182 | 80.2 | 49 | 22 | 17 | -22.7 | 47 |
| California | 415 | 451 | 8.7 | 24 | 64 | 29 | -54.7 | 32 |
| Colorado | 271 | 521 | 92.3 | 20 | 46 | 36 | -21.7 | 23 |
| Connecticut | 369 | 731 | 98.1 | 7 | 53 | 41 | -22.6 | 16 |
| Delaware | 130 | 223 | 71.5 | 44 | 19 | 16 | -15.8 | 49 |
| Florida | 191 | 411 | 115.2 | 28 | 34 | 31 | -8.8 | 28 |
| Georgia | 178 | 329 | 84.8 | 36 | 35 | 27 | -22.9 | 36 |
| Hawaii | 174 | 314 | 80.5 | 37 | 27 | 23 | -14.8 | 41 |
| Idaho | 190 | 299 | 57.4 | 38 | 37 | 27 | -27.0 | 35 |
| Illinois | 284 | 539 | 89.8 | 17 | 42 | 37 | -11.9 | 22 |
| Indiana | 226 | 393 | 73.9 | 31 | 40 | 32 | -20.0 | 27 |
| Iowa | 278 | 544 | 95.7 | 16 | 46 | 43 | -6.5 | 14 |
| Kansas | 274 | 533 | 94.5 | 18 | 46 | 39 | -15.2 | 19 |
| Kentucky | 105 | 195 | 85.7 | 47 | 22 | 18 | -18.2 | 46 |
| Louisiana | 90 | 189 | 110.0 | 48 | 19 | 17 | -10.5 | 48 |
| Maine | 297 | 478 | 60.9 | 22 | 63 | 41 | -34.9 | 17 |
| Maryland | 239 | 438 | 83.3 | 26 | 37 | 28 | -24.3 | 33 |
| Massachusetts | 431 | 601 | 39.4 | 12 | 70 | 37 | -47.1 | 21 |
| Michigan | 324 | 650 | 100.6 | 10 | 52 | 48 | -7.7 | 6 |
| Minnesota | 254 | 529 | 108.3 | 19 | 44 | 38 | -13.6 | 20 |
| Mississippi | 110 | 221 | 100.9 | 45 | 27 | 24 | -11.1 | 38 |
| Missouri | 195 | 243 | 24.6 | 41 | 35 | 19 | -45.7 | 45 |
| Montana | 350 | 650 | 85.7 | 9 | 65 | 59 | -9.2 | 3 |
| Nebraska | 319 | 579 | 81.5 | 14 | 53 | 43 | -18.9 | 12 |
| Nevada | 272 | 340 | 25.0 | 35 | 42 | 24 | -42.9 | 39 |
| New Hampshire | 348 | 738 | 112.1 | 6 | 66 | 51 | -22.7 | 5 |
| New Jersey | 446 | 757 | 69.7 | 4 | 67 | 44 | -34.3 | 11 |
| New Mexico | 103 | 143 | 38.8 | 50 | 22 | 13 | -40.9 | 50 |
| New York | 412 | 748 | 81.6 | 5 | 63 | 47 | -25.4 | 7 |
| North Carolina | 130 | 265 | 103.8 | 39 | 26 | 23 | -11.5 | 40 |
| North Dakota | 212 | 364 | 71.7 | 34 | 37 | 30 | -18.9 | 29 |
| Ohio | 224 | 394 | 75.9 | 30 | 38 | 30 | -21.1 | 30 |
| Oklahoma | 124 | 234 | 88.7 | 43 | 24 | 19 | -20.8 | 44 |
| Oregon | 333 | 651 | 95.5 | 8 | 59 | 52 | -11.9 | 4 |
| Pennsylvania | 176 | 388 | 120.5 | 32 | 30 | 29 | -3.3 | 31 |
| Rhode Island | 294 | 624 | 112.2 | 11 | 50 | 45 | -10.0 | 10 |
| South Carolina | 116 | 260 | 124.1 | 40 | 25 | 25 | 0.0 | 37 |
| South Dakota | 288 | 477 | 65.6 | 23 | 59 | 43 | -27.1 | 13 |
| Tennessee | 129 | 235 | 82.2 | 42 | 27 | 21 | -22.2 | 42 |
| Texas | 213 | 517 | 142.7 | 21 | 39 | 39 | 0.0 | 18 |
| Utah | 172 | 366 | 112.8 | 33 | 36 | 35 | -2.8 | 24 |
| Vermont | 308 | 556 | 80.5 | 15 | 63 | 46 | -27.0 | 8 |
| Virginia | 173 | 396 | 128.9 | 29 | 30 | 28 | -6.7 | 34 |
| Washington | 236 | 442 | 87.3 | 25 | 38 | 32 | -15.8 | 26 |
| West Virginia | 106 | 203 | 91.5 | 46 | 22 | 20 | -9.1 | 43 |
| Wisconsin | 289 | 600 | 107.6 | 13 | 51 | 46 | -9.8 | 9 |
| Wyoming | 352 | 1,173 | 233.2 | 1 | 60 | 88 | 46.7 | 1 |
| District of Columbia | 210 | 773 | 268.1 | 3 | 27 | 43 | 59.3 | 15 |

Source: Department of Commerce, Bureau of the Census; and Tax Foundation computations.

(TAX BURDEN, *from page 2*)

## Estimated Federal Total and Per Capita Tax Burden by State

### Fiscal Years 1987-1989

($Millions)

| State | Federal Total Tax Burden | | | Federal Funds Tax Burden | | | Per Capita Burden (Dollars) | | | State Rank 1988 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1987 | 1988 | 1989 | 1987 | 1988 | 1989 | 1987 | 1988 | 1989 | Total | Per Capita |
| U.S.Total | $ 830,536 | $ 885,116 | $ 940,290 | $ 514,478 | $ 538,872 | $ 570,568 | $ 3,414 | $ 3,603 | $ 3,790 | — | — |
| Alabama | 10,209 | 10,893 | 11,568 | 6,072 | 6,357 | 6,727 | 2,505 | 2,656 | 2,802 | 25 | 43 |
| Alaska | 2,419 | 2,560 | 2,713 | 1,464 | 1,519 | 1,605 | 4,358 | 4,430 | 4,506 | 46 | 5 |
| Arizona | 10,209 | 10,915 | 11,608 | 6,368 | 6,668 | 7,086 | 2,991 | 3,108 | 3,213 | 24 | 33 |
| Arkansas | 5,633 | 6,042 | 6,421 | 3,241 | 3,418 | 3,623 | 2,371 | 2,536 | 2,690 | 32 | 48 |
| California | 104,606 | 111,631 | 118,703 | 65,052 | 68,193 | 72,221 | 3,806 | 3,985 | 4,158 | 1 | 11 |
| Colorado | 11,322 | 12,081 | 12,843 | 7,040 | 7,382 | 7,818 | 3,406 | 3,570 | 3,728 | 23 | 19 |
| Connecticut | 16,402 | 17,398 | 18,481 | 10,815 | 11,261 | 11,910 | 5,124 | 5,410 | 5,720 | 16 | 1 |
| Delaware | 2,486 | 2,648 | 2,813 | 1,472 | 1,538 | 1,628 | 3,890 | 4,106 | 4,321 | 44 | 8 |
| Flordia | 40,820 | 43,585 | 46,379 | 27,638 | 29,054 | 30,804 | 3,409 | 3,547 | 3,678 | 5 | 21 |
| Georgia | 18,782 | 20,023 | 21,270 | 11,522 | 12,042 | 12,741 | 3,029 | 3,177 | 3,320 | 12 | 29 |
| Hawaii | 3,449 | 3,688 | 3,924 | 2,057 | 2,161 | 2,288 | 3,206 | 3,378 | 3,544 | 40 | 24 |
| Idaho | 2,455 | 2,632 | 2,796 | 1,369 | 1,448 | 1,535 | 2,428 | 2,581 | 2,717 | 45 | 47 |
| Illinois | 43,850 | 46,638 | 49,511 | 27,231 | 28,501 | 30,174 | 3,789 | 4,020 | 4,257 | 4 | 10 |
| Indiana | 16,590 | 17,712 | 18,830 | 10,305 | 10,794 | 11,428 | 3,012 | 3,212 | 3,409 | 15 | 27 |
| Iowa | 8,208 | 8,797 | 9,351 | 4,862 | 5,144 | 5,459 | 2,887 | 3,100 | 3,302 | 30 | 34 |
| Kansas | 8,285 | 8,851 | 9,409 | 5,089 | 5,345 | 5,664 | 3,349 | 3,555 | 3,753 | 29 | 20 |
| Kentucky | 9,108 | 9,724 | 10,325 | 5,484 | 5,761 | 6,101 | 2,435 | 2,591 | 2,742 | 27 | 46 |
| Louisiana | 11,560 | 12,315 | 13,067 | 7,064 | 7,402 | 7,836 | 2,564 | 2,726 | 2,886 | 22 | 41 |
| Maine | 3,268 | 3,494 | 3,712 | 1,967 | 2,069 | 2,192 | 2,769 | 2,941 | 3,104 | 42 | 37 |
| Maryland | 18,351 | 19,533 | 20,757 | 11,454 | 11,959 | 12,654 | 4,079 | 4,303 | 4,533 | 13 | 7 |
| Massachusetts | 24,874 | 26,456 | 28,114 | 15,991 | 16,704 | 17,678 | 4,254 | 4,510 | 4,777 | 10 | 4 |
| Michigan | 32,959 | 34,996 | 37,100 | 19,793 | 20,692 | 21,897 | 3,609 | 3,835 | 4,069 | 9 | 12 |
| Minnesota | 14,450 | 15,457 | 16,434 | 8,425 | 8,859 | 9,387 | 3,412 | 3,629 | 3,838 | 20 | 17 |
| Mississippi | 5,345 | 5,723 | 6,080 | 3,109 | 3,269 | 3,461 | 2,024 | 2,153 | 2,273 | 33 | 51 |
| Missouri | 16,292 | 17,397 | 18,489 | 10,104 | 10,609 | 11,240 | 3,202 | 3,401 | 3,596 | 17 | 23 |
| Montana | 2,160 | 2,315 | 2,460 | 1,258 | 1,330 | 1,412 | 2,621 | 2,793 | 2,946 | 47 | 40 |
| Nebraska | 4,774 | 5,126 | 5,457 | 2,842 | 2,999 | 3,181 | 2,980 | 3,188 | 3,383 | 34 | 28 |
| Nevada | 3,580 | 3,794 | 4,023 | 2,379 | 2,481 | 2,624 | 3,624 | 3,738 | 3,861 | 39 | 13 |
| New Hampshire | 4,056 | 4,315 | 4,588 | 2,656 | 2,770 | 2,930 | 3,888 | 4,071 | 4,260 | 36 | 9 |
| New Jersey | 36,840 | 39,083 | 41,474 | 23,504 | 24,525 | 29,951 | 4,811 | 5,075 | 5,356 | 7 | 2 |
| New Mexico | 3,822 | 4,087 | 4,342 | 2,291 | 2,406 | 2,549 | 2,538 | 2,664 | 2,780 | 38 | 42 |
| New York | 72,710 | 77,480 | 82,374 | 45,368 | 47,499 | 50,300 | 4,083 | 4,339 | 4,601 | 2 | 6 |
| North Carolina | 17,920 | 19,124 | 20,314 | 10,630 | 11,129 | 11,778 | 2,800 | 2,955 | 3,104 | 14 | 36 |
| North Dakota | 1,887 | 2,019 | 2,145 | 1,151 | 1,213 | 1,286 | 2,763 | 2,939 | 3,099 | 48 | 38 |
| Ohio | 35,304 | 37,644 | 39,977 | 20,994 | 22,001 | 23,295 | 3,284 | 3,500 | 3,716 | 8 | 22 |
| Oklahoma | 9,548 | 10,173 | 10,800 | 5,895 | 6,166 | 6,526 | 2,853 | 3,000 | 3,143 | 26 | 35 |
| Oregon | 8,074 | 8,635 | 9,170 | 4,680 | 4,935 | 5,234 | 2,982 | 3,175 | 3,557 | 31 | 30 |
| Pennsylvania | 40,029 | 42,622 | 45,225 | 24,108 | 25,287 | 26,781 | 3,365 | 3,579 | 3,792 | 6 | 18 |
| Rhode Island | 3,434 | 3,660 | 3,886 | 2,013 | 2,112 | 2,237 | 3,508 | 3,720 | 3,929 | 41 | 14 |
| South Carolina | 8,440 | 9,019 | 9,582 | 4,975 | 5,214 | 5,518 | 2,472 | 2,610 | 2,740 | 28 | 45 |
| South Dakota | 1,737 | 1,872 | 1,993 | 1,014 | 1,074 | 1,140 | 2,443 | 2,621 | 2,780 | 49 | 44 |
| Tennessee | 13,315 | 14,201 | 15,086 | 8,098 | 8,465 | 8,955 | 2,754 | 2,916 | 3,076 | 21 | 39 |
| Texas | 55,196 | 58,648 | 62,260 | 35,515 | 37,031 | 39,164 | 3,235 | 3,360 | 3,486 | 3 | 25 |
| Utah | 3,940 | 4,217 | 4,481 | 2,271 | 2,386 | 2,526 | 2,323 | 2,440 | 2,543 | 37 | 50 |
| Vermont | 1,603 | 1,710 | 1,814 | 972 | 1,023 | 1,084 | 2,942 | 3,109 | 3,268 | 50 | 32 |
| Virginia | 20,565 | 21,928 | 23,318 | 13,081 | 13,682 | 14,482 | 3,514 | 3,702 | 3,891 | 11 | 15 |
| Washington | 15,607 | 16,610 | 17,624 | 9,555 | 10,018 | 10,610 | 3,460 | 3,639 | 3,817 | 18 | 16 |
| West Virginia | 4,459 | 4,755 | 5,043 | 2,655 | 2,788 | 2,952 | 2,330 | 2,487 | 2,642 | 35 | 49 |
| Wisconsin | 15,080 | 16,086 | 17,064 | 8,770 | 9,232 | 9,785 | 3,144 | 3,342 | 3,534 | 19 | 26 |
| Wyoming | 1,543 | 1,642 | 1,739 | 953 | 998 | 1,057 | 3,014 | 3,169 | 3,319 | 51 | 31 |
| Dist. of Columbia | 2,973 | 3,155 | 3,350 | 1,856 | 1,935 | 2,047 | 4,757 | 5,057 | 5,376 | 43 | 3 |

Source: Total U.S. taxes as shown in the Fiscal Year 1989 Budget of the U.S. Government.
Computations of total and per capita tax burden by state were made by Tax Foundation.

(MULTINATIONALS, *from page 2*)

country tax on foreign operation and income; foreign tax credit utilization rules which determine the ability of a company to avoid double taxation on foreign income; and the extent to which tax treaties modify these rules. Among the major findings are:

1. When exemptions or deferrals, foreign tax credits and tax treaties are taken into account, the U.S. multinationals very well can be at the highest end of the effective tax rate scale on foreign operations compared to the other three countries. In fact, even though the 1986 tax act lowered the nominal corporate tax rates, many U.S. companies will face increased tax liability on foreign source income.

2. The U.S. has no treaty in which it agrees to "spare" U.S. tax on income that could have been but was not taxed by a lesser developed country, while the other three nations have many such "tax sparing" treaties. The absence of such an incentive for U.S. companies hinders their ability to access the low-cost labor and raw materials of Third World countries in a way that would enable these companies to compete equally in world trade.

A major U.S.-based computer manufacturer that sets up a manufacturing facility in Singapore, which grants a tax holiday to such an operation, nevertheless pays the effective corporate U.S. tax rate of 34 percent on repatriated revenues. By comparison, Dutch and German companies enjoy a home country exemption, resulting in a zero percent worldwide tax rate. Japanese companies pay a 56 percent nominal tax rate; however, since Japan has a 33 percent tax sparing credit for Singapore, such a company would pay only a 23 percent effective tax rate.

An additional competitive disadvantage for U.S. multinationals results from the relative instability of the U.S. tax system, with changes to the system occurring or threatened every year or two for the past 20 years. "The ability of U.S. companies to do long-term business planning has been severely hampered for many years because of consistent changes in our tax laws, further weakening our competitive posture worldwide," Gladstone charged.

* * *

*Note: Copies of "The Competitive Burden: Tax Treatment of U.S. Multinationals," 64 pages, are available for $6 plus $1 for postage and handling from the Tax Foundation, One Thomas Circle, N.W., Suite 500, Washington, DC 20005. (202) 822-9050*

(PROPERTY TAX, *from page 1*)

District of Columbia ($773). States with lowest per capita collections were Alabama ($118), New Mexico ($143), and Arkansas ($182).

In terms of the decade's percentage rate of growth in per capita property taxes, the District of Columbia, Wyoming and Texas headed the list. Altogether, 16 states and the District of Columbia reported a doubling or more in per capita property taxes. No state reported a decline in per capita property taxes between 1976 and 1986.

### Per $1,000 of Personal Income

Property taxes per $1,000 of state personal income were highest in Wyoming ($88), Alaska ($61), and Montana ($59) as compared to the national average of $34. The lowest property tax burdens by this yardstick were in Alabama ($11), New Mexico ($13) and Delaware ($16).

During the decade only two jurisdictions experienced increases in property taxes in relation to personal income — the District of Columbia (up 59 percent), and Wyoming (up 47 percent). The sharpest reduction in the taxes/income ratio for the decade occurred in California (down 55 percent), Alaska (49 percent), and Massachusetts (47 percent).

*(Complete table on page 6)*

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TAX FOUNDATION'S VOL. 32, NO. 3 APRIL/MAY 1988

# TAX·FEATURES

# Tax Freedom Day 1988 Is May 5; Two Days Later Than 1987

## *Workers Lose Two More Minutes Of a Day's Pay to Tax Bite*

Another perspective on the tax burden is revealed by the tax bite in the typical worker's 8-hour day. In 1988, that worker will spend 2 hours and 45 minutes on the job for the tax collector, two minutes more than in 1987, and the largest tax bite since U.S. tax statistics began to be recorded early in this century. Of that period,

*(Continued on page 2)*

### Tax Freedom Day and Tax Bite in 8-Hour Day

| Year | Tax Freedom Day | Tax Bite in the Eight-Hour Day | | |
|---|---|---|---|---|
| | | Total | Federal | State/ Local |
| 1955 | April-9 | 2:09 | 1:34 | 0:35 |
| 1956 | April-11 | 2:13 | 1:37 | 0:36 |
| 1957 | April-13 | 2:14 | 1:37 | 0:37 |
| 1958 | April-10 | 2:12 | 1:32 | 0:40 |
| 1959 | April-14 | 2:16 | 1:36 | 0:40 |
| 1960 | April-17 | 2:22 | 1:40 | 0:42 |
| 1961 | April-18 | 2:22 | 1:38 | 0:44 |
| 1962 | April-18 | 2:21 | 1:38 | 0:43 |
| 1963 | April-19 | 2:23 | 1:39 | 0:44 |
| 1964 | April-15 | 2:18 | 1:33 | 0:45 |
| 1965 | April-15 | 2:17 | 1:33 | 0:44 |
| 1966 | April-18 | 2:21 | 1:36 | 0:45 |
| 1967 | April-20 | 2:24 | 1:37 | 0:47 |
| 1968 | April-25 | 2:32 | 1:39 | 0:53 |
| 1969 | May-1 | 2:38 | 1:48 | 0:50 |
| 1970 | April-28 | 2:34 | 1:40 | 0:54 |
| 1971 | April-25 | 2:31 | 1:36 | 0:55 |
| 1972 | April-29 | 2:36 | 1:39 | 0:57 |
| 1973 | April-29 | 2:36 | 1:41 | 0:55 |
| 1974 | May-3 | 2:41 | 1:45 | 0:56 |
| 1975 | April-28 | 2:35 | 1:38 | 0:57 |
| 1976 | May-1 | 2:40 | 1:42 | 0:58 |
| 1977 | May-3 | 2:41 | 1:43 | 0:58 |
| 1978 | May-3 | 2:41 | 1:45 | 0:56 |
| 1979 | May-3 | 2:41 | 1:48 | 0:53 |
| 1980 | May-1 | 2:39 | 1:48 | 0:51 |
| 1981 | May-4 | 2:43 | 1:52 | 0:51 |
| 1982 | May-3 | 2:41 | 1:48 | 0:53 |
| 1983 | April-30 | 2:38 | 1:43 | 0:55 |
| 1984 | April-28 | 2:36 | 1:42 | 0:54 |
| 1985 | April-30 | 2:38 | 1:44 | 0:54 |
| 1986 | April-30 | 2:38 | 1:43 | 0:55 |
| 1987 | May-4 | 2:43 | 1:48 | 0:55 |
| 1988 | May-5 | 2:45 | 1:50 | 0:55 |

Source: Department of Commerce, Bureau of Economic Analysis; and Tax Foundation computations.

The bad news is that Tax Freedom Day 1988 is May 5. The worse news is that, although Tax Freedom Day last year was May 4th, this year's date is two days later than 1987 because 1988 is leap year.

Economists at the Tax Foundation announced today that the average American would work from January 1 through May 4 to furnish Federal, state and local tax collectors with the funds to pay all taxes, if every cent earned from the first of the year went for taxes. On May 5, Americans finally start working for themselves.

Put another way, it will take 126 days to satisfy the tax man this year, two days longer than were required last year. This way of expressing the tax load is calculated on the assumption that, sooner or later, the American "worker" ultimately pays the total tax burden — including business taxes which are passed on to individuals — in his or her capacity as an employee, proprietor, or investor.

Uncle Sam did it, counsel economists at the Washington-based tax watchdog organization.

*(Continued on page 2)*

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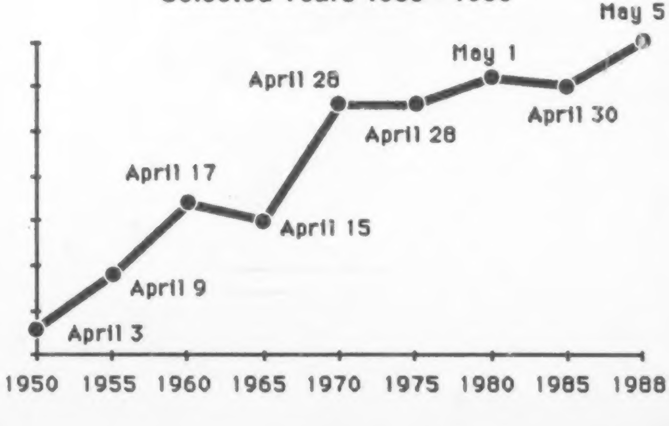
**"State Tax & Fiscal Prospects"**

**Tax Freedom Day**
**Selected Years 1950 - 1988**



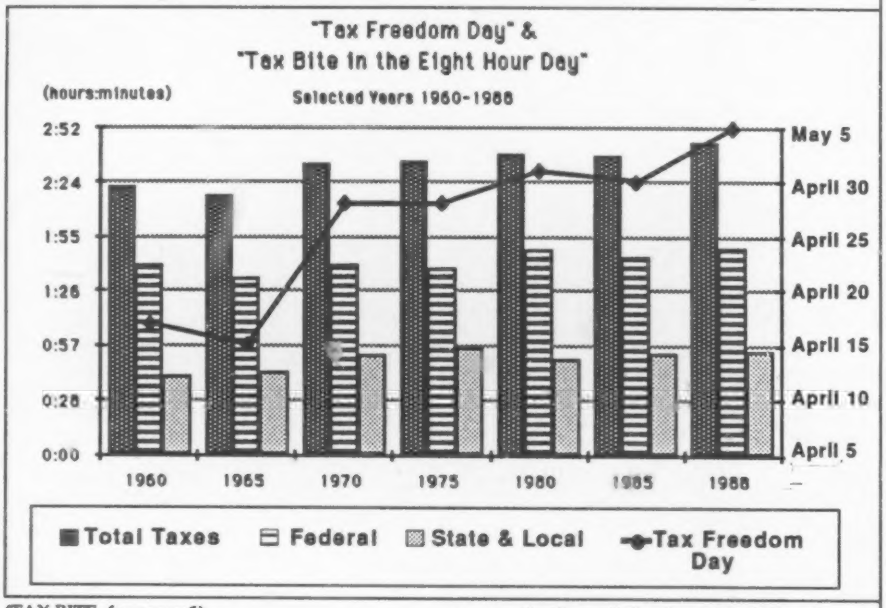
(TAX FREEDOM DAY, *from page 1*)

Increases in the corporate income tax passed in the Tax Reform Act of 1986 (TRA86) are continuing to kick in; the Omnibus Budget Reconciliation Act of 1987 has loaded an estimated $9.1 billion on taxpayers; a large increase in social insurance taxes has taken hold; and the Continuing Resolution for 1988 increased Federal receipts an estimated $2.4 billion this year, taking an additional $1 billion from individual income taxes alone. Combined, the '87 Reconciliation Act and the '88 Continuing Resolution have boosted the 1988 Federal take by $11.5 billion.

The U.S. taxpayer has now lost all the ground gained through the major cuts of the Economic Recovery Tax Act of 1981 (ERTA). Since ERTA, large revenue raisers in 1982, 1983, and 1984, plus the 1987 omnibus bill and the 1988 continuing resolution, have lopped off big chunks of the '81 cuts and social security hikes have made further inroads, until, like the Cheshire Cat in Alice in Wonderland, nothing remains but the smile.

State/local taxes will increase in 1988, but not faster than the economy as they did over the previous six years. Also, the states receive an ongoing windfall as the effects of TRA86 continue to make state levies generally more progressive. Although some states changed their laws to avoid such windfalls, others opted to keep revenue gains, and they will rake in an estimated $1.1 billion extra this year.

Tax Freedom Day grows later. In 1930, it fell on February 13. By 1940, it had moved to March 8, and to April 3 by 1950. In 1980, it coincided with May Day, and after a few years of relief under the 1981 tax cuts, it renewed its march further intoMay.

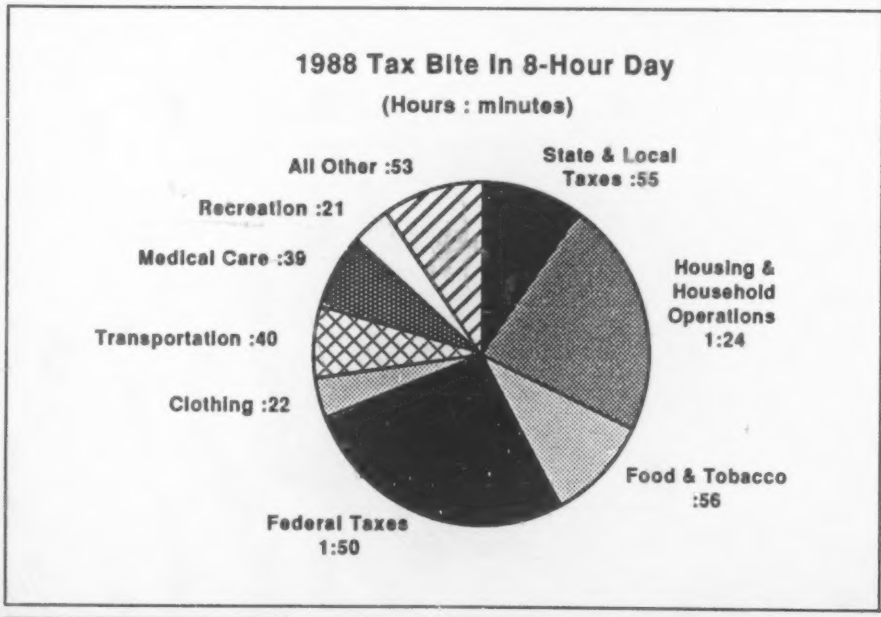


(TAX BITE, *from page 1*)

1hour 50 minutes goes to Washington, and 55 minutes go to states and municipalities, say economists at the Foundation.

As the accompanying table shows, the extra allocation for the two minute tax boost comes from the "Food and Tobacco" and "Clothing" categories, which lost 2 minutes and 1 minute, respectively, while the "All Other" category (personal care, personal business, private education, religious and welfare activities, net foreign travel, and net savings) will require an additional minute's labor.

In sum, what the average consumer managed to save on the price of clothes, food and smokes, was gobbled up by the tax collector.



### "Tax Bite In the Eight-Hour Day"

1987 - 1988

(hours:minutes)

| | 1987 | 1988 |
|---|---|---|
| **Total Taxes** | 2:43 | 2:45 |
| Federal | 1:48 | 1:50 |
| State and Local | :55 | :55 |
| **Personal Consumption Expenditures** | 5:17 | 5:15 |
| Housing and Household Operations | 1:24 | 1:24 |
| Food and Tobacco | :58 | :56 |
| Transportation | :40 | :40 |
| Medical Care | :39 | :39 |
| Clothing | :23 | :22 |
| Recreation | :21 | :21 |
| All Other | :52 | :53 |
| **8-Hour Day** | 8:00 | 8:00 |

*Budget Watch* By Allen Schick

# The Defense Roller Coaster

Budgeting has never been a calm, stable activity for the Pentagon. More than any other federal agency, its budget goes through wide swings. In the past, the defense budget cycle usually reflected changes in military conditions. War brought an escalation in defense spending; peace led to a decline. In the 1980s, however, the cycle has been influenced more by political than military factors.

The vicissitudes in the defense budget are starkly displayed in the table that accompanies this article. Between 1979 and 1985, the money provided for national defense (including some funds spent outside the Pentagon) soared from $126 billion to $294 billion, making this the biggest peacetime buildup in U.S. history. Since then, however, defense spending has been virtually frozen; in real (inflation-adjusted) dollars, national defense will get $35 billion less in fiscal 1989 than it received four years earlier.

These zigzags correspond to shifts in public opinion. Most Americans (58% in a Gallup Poll) favored the defense buildup at the start of the 1980s; most (80% in a recent poll) now think that defense spending should remain about the same or be decreased.

**What the Money Bought**

When the political cycle swings in favor of defense, the Pentagon goes on a buying spree, acquiring as many new weapons and forces as possible. The early 1980s conformed to this pattern. During the buildup phase of the cycle, the portion of the defense budget allocated to procurement rose from 25% to 33%. This behavior has often been criticized as wasteful, but it is mostly due to defense's boom and bust budgets. There are three main reasons why this cycle skews spending in favor of big ticket purchases.

When defense spending is depressed, the research phase is stretched out because the Defense Department doesn't have sufficient funds to acquire the weapons it has been developing. Then, when spending moves upward, it faces pent-up demand for procurement;

The Pentagon knows that if it does not obtain additional funds when support is high, it will not be able to do so when the cycle turns. Investing in weapons is its characteristic way of adjusting to the instability of the process.

**The Defense Budget**
**Fiscal Years**
**Dollar Figures in Billions**

| | 1979 | 1985 | 1989 est. |
|---|---|---|---|
| New budget authority | $ 126.5 | $ 294.7 | $ 299.5 |
| Real (inflation-adjusted budget authority) | 208.9 | 325.5 | 290.8 |
| Total outlays | 116.3 | 252.7 | 294.0 |
| **Defense Spending by Category (percent)** | | | |
| Military personnel | 29.7% | 23.0% | 26.2% |
| Operations and maintenance | 30.1 | 26.4 | 28.6 |
| Procurement | 24.8 | 32.8 | 26.7 |
| Research and development | 9.8 | 10.6 | 12.8 |
| Other | 5.3 | 7.1 | 5.7 |

Major weapons have long leadtimes stretching to as much as a decade. Despite the long lead times, Congress makes annual budget decisions for defense. Each year's appropriations depend on that year's political mood. It is difficult, therefore, to plan an orderly research-development-acquisition process, because the Pentagon does not know how much support it will have in Congress when the weapons are ripe for procurement.

Because of these cyclical factors, the share of defense spending allocated to research and development declined during the early years of the Reagan buildup. In recent years, however, R & D has substantially increased its share. This suggested that the Pentagon is developing a new generation of weapons which will be ready when the next escalation in spending occurs.

**Adjusting to the Downturn**

Although it cannot know how long the current downturn will persist, the Defense Department must now adapt to more austere circumstances. The adjustment has been eased by the accumulation of more than $250 billion in carryover balances, funds appropriated in prior years but not yet spent. These balances have made it possible to maintain high production levels. But they also have made the defense budget more rigid: 40% of defense outlays now result from obligations incurred in previous years. When personnel and related costs are included, about 85 cents out of every defense dollar is locked into hard-to-control expenses.

If the downtrend in spending is prolonged, the Pentagon will not be able to count on carryover funds to tide it over until better times return. The typical way of adjusting to this situation has been to stretch out military procurement (buying fewer tanks, planes, and ships), to draw down on ordinance and spare parts, and to cutback on training and military readiness. This approach has the advantage of enabling the Department

*(Continued on page 8)*

# Moderate Income American Family Will Pay Total Federal Taxes of $7,943 in Fiscal 1988

### How the Federal Government Will Spend a Worker's Tax Dollar in Fiscal Year 1988(a)

| Function | Worker's Share Amount | Worker's Share Percent of Total | Total Spending ($Millions) |
|---|---|---|---|
| Income Security (b) | $ 2,540 | 31.98 | $ 349,277 |
| National Defense | 2,076 | 26.14 | 285,423 |
| Net Interest | 1,075 | 13.54 | 147,871 |
| Health (c) | 897 | 11.29 | 123,336 |
| Education, Training, Employment, and Social Services | 245 | 3.08 | 33,652 |
| Veterans' Benefits and Services | 202 | 2.54 | 27,748 |
| Transportation | 198 | 2.49 | 27,237 |
| Agriculture | 163 | 2.05 | 22,352 |
| Natural Resources and Environment | 110 | 1.39 | 15,139 |
| Commerce and Housing Credit | 90 | 1.13 | 12,364 |
| General Science, Space, and Technology | 79 | 0.99 | 10,903 |
| International Affairs | 72 | 0.91 | 9,926 |
| Administration of Justice | 65 | 0.82 | 8,970 |
| General Government | 64 | 0.81 | 8,796 |
| Community and Regional Development | 46 | 0.58 | 6,321 |
| Energy | 20 | 0.25 | 2,713 |
| Total (d) | $ 7,943 | 100.00 | $ 1,055,904 |
| Exhibit: | | | |
| Payments for Individuals | $ 3,628 | 45.68 | $ 498,867 |

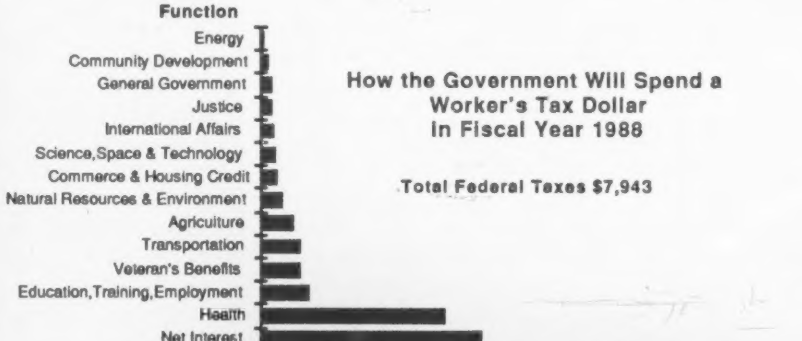
(a) In this example, the worker is the sole source of support for a spouse and two dependent children earning $ 30,000 per year.

(b) Includes social security, Federal employee retirement, unemployment compensation, housing assistance, and food and nutrition assistance; excludes veteran's income security.

(c) Includes Medicare, Medicaid, and others; excludes veterans' hospital and medical care.

(d) After deducting $ 36,123 million in undistributed offsetting receipts not classified by function.

Source: Tax Foundation computations, based on Fiscal Year 1989 U.S. Budget presented February 18, 1988 and tax laws for 1988 from the Treasury Department.



How the Government Will Spend a Worker's Tax Dollar in Fiscal Year 1988

Total Federal Taxes $7,943

A moderate-income family—one worker earning $30,000 with a spouse and two dependent children faces a tax bill of $7,943 for fiscal year 1988. That covers the family's direct as well as indirect Federal taxes. Add to this their $1,316 share of the Federal deficit, and the family will pay $9,259 to support the estimated $1.06 trillion Uncle Sam plans to spend in fiscal year 1988.

Economists at the Tax Foundation use this prototypical family to show where the average American household's tax dollars will go. Assuming that the $7,943 tax bill is allocated to cover the family's whole share of Federal spending, the following expenditures stand out.

Income security costs the most at $349.3 billion. This comprises Social Security, Federal retirement, unemployment compensation, housing assistance and nutrition assistance. The Federal government will pay out 32 cents for income security programs for each $1 this taxpayer sends to Washington, a total of $2,540.

National Defense will cost $285.4 billion-or 26 cents out of each tax dollar. For the moderate-income taxpayer described here, this amounts to $2,076.

Interest on the public debt ranks third at $147.9 billion, costing this worker over 13 cents of his tax dollar or a whopping $1,075.

Health outlays, mainly Medicare and Medicaid, will take over 11 cents of each tax dollar. This earner will send Uncle Sam $897 to pay for the $123.3 billion national health bill.

These four programs alone will claim almost 83 percent of all Federal spending and will cost this moderate-income taxpayer $6,588 in taxes.

However, direct levies do not explain the whole tax picture, accounting for only about three-fifths of the total Federal tax take. To these must be added such indirect taxes as

*(Continued on page 5)*

(WORKER'S TAX DOLLAR, *from page 4*)

employer's share of Social Security taxes; corporate income taxes; excise taxes on such items as gasoline, liquor and tobacco; and miscellaneous levies. These will take another $3,069 from the moderate-earner's paycheck.

Direct and indirect Federal taxes claim over 26 percent of this family's annual income. But even that does not tell the whole story. All told, current Federal taxes and borrowing add up to nearly 31 percent of this moderate-income family's earnings.

The accompanying table and chart provide further details.

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# THE FRONT BURNER

**By Robert C. Brown**
**President, Tax Foundation**

## "Capital Gains Aren't Just for the Rich"

*The following guest "Front Burner" first appeared as a Letter to the Editor in the Washington Post, March 26, 1988. It is reproduced with permission.*

Your March 15 editorial on "Capital Gains and Fairness" sure made me mad! A Friend in Washington called and read the editorial to me, and I put this response to you in a purple airplane the next day so that he could drop it at your office while it was still hot.

Your statement that 50 percent of the capital gains go to upper-income people may be true, but that means that the other 50 percent goes to those of us in lower brackets. It doesn't take much of a tax increase to put us out of business. If we are going to talk fairness, it shouldn't matter whether you're rich or poor when it comes to how capital gains are taxed.

I just did my taxes, and your comments about millionaires hit me like salt on a sunburnt blister. I finally made a sale on some trees that I've been growing half a lifetime, and the new tax rates are taking 71 percent more of my income than under the old rules. That's a lot of money to me. It would replace my old pickup truck. It would reforest 150 acres of land. It would more than pay for the forestry consultant I hire to make sure my forest is in good shape. The topping on this bitter cake is that the paper work required to complete the process of being fleeced has more than doubled.

In spite of what the tax laws have done to me, I'm going to plant trees to replace those I've cut, and I'm going to hire foresters to keep my forest in prime condition. This farm goes back in my family a long time, and I want it to go forward for my family and others into the future.

I'll continue to take care of my land and send my money to Washington, but I'll feel like I've been treated badly. I've been planting and growing trees for 50 years now, and I've been through forest fires and tornadoes and droughts and ice storms, but the new tax laws are the biggest mess I've ever seen and the most discouraging to tree farmers. If the trend continues, we will eventually do all the work and take all the risks and then send all the money to Washington.

You mention that a bargain was stuck on taxes less than two years ago and that the bargain should not be broken. The deal you speak of is no bargain. It broke an implied commitment made to forest landowners more than 40 years ago, when the tax rates for long-term investments were lowered.

The more than 4 million American who own important tracts of forest land are unfairly treated under the new rules. These are ordinary folks, who sometimes wait a lifetime for some income from their forests. Many of them established their forests more than 40 years ago under that first "bargain" struck with Congress. The agreement at that time recognized that private forestry operations were risky, long-term investments, deserving of lower rate taxation of capital gains. There was also recognition that tax policy sets land-use policy and that if the nation approved of the conservation of private forests, a tax system that encouraged long-term investments would "put our money where our mouth was."

I think we landowners have kept our side of the long-term commitment. Although some forests certainly aren't as well cared for as I would like to see, overall we have planted billions of trees and constantly improved the application of forestry to the land. Most of us have done this work because we care about the land, but it sure helped to know that we got to keep some of our gains after years of work.

You use a lot of trees in putting out your paper, but your editorial ignored what it takes to grow those trees. Look outside Washington and the law books if you want to know what the system does.

C. M. Stripling
Camilla, GA

# *Sales Taxes Rake in Revenue for States*

Sales taxes produce more revenue for the states than any other source, according to recent analysis by the Tax Foundation. Economists at the Washington-based tax watchdog organization say that in the 45 states which levy general sales taxes, $79.8 billion was brought in to state treasuries in fiscal year 1987 — almost a third (32.3%) of the $247.1 billion total state tax collections for that year.

The personal income tax ranked second, bringing in $76 billion during fiscal 1987 for 30.8% of total tax receipts, a hefty 12.7% increase over 1986's take. Corporate income taxes, the third largest single tax source, also showed a sizeable jump, amounting to $20.7 billion, 8.4% of the total. Only five states (Nevada, South Dakota, Texas, Washington, and Wyoming) have neither a corporate nor a personal income tax, and only seven states (the previous five plus Alaska and Florida) have no individual income tax.

All states tax gasoline and motor fuels; this source netted $15.7 billion, 6.3% of their total taxes in fiscal 1987.

Local property taxes are levied in all 50 states, and 39 have state property taxes; 39 states have both general sales and income taxes; and 33 states have general sales, income, and property taxes, Tax Foundation economists say.

## State Sales Taxes

Connecticut led the list for top rates with its 7.5% sales and use tax rate, followed by: Washington (6.5%); Minnesota, Mississippi, New Jersey, Pennsylvania, Rhode Island, Florida and Texas (6%); and Nevada (5.75%). No state general sales tax is levied in Alaska, Delaware, Montana, New Hampshire, or Oregon, although municipalities in Alaska do impose sales tax.

The state sales tax is lowest — 3% — in four states: Colorado, Georgia, North Carolina, and Wyoming. Localities in 28 states levy sales taxes, generally in addition to those shown in the accompanying table.

## Income Tax Rates

Minnesota (14%) and Iowa (13%) have the highest marginal individual income tax rates. The rate schedules are progressive (i.e., rise as income brackets go up) in all but five states. Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania apply a flat rate, regardless of income level. In three states, income taxes are levied as a percentage of Federal individual income tax obligations — Nebraska, Rhode Island, and Vermont.

The maximum corporate income tax rates are highest in Iowa and Minnesota (12%); Connecticut (11.5%); Arizona and North Dakota (10.5%); and California (9.3%).

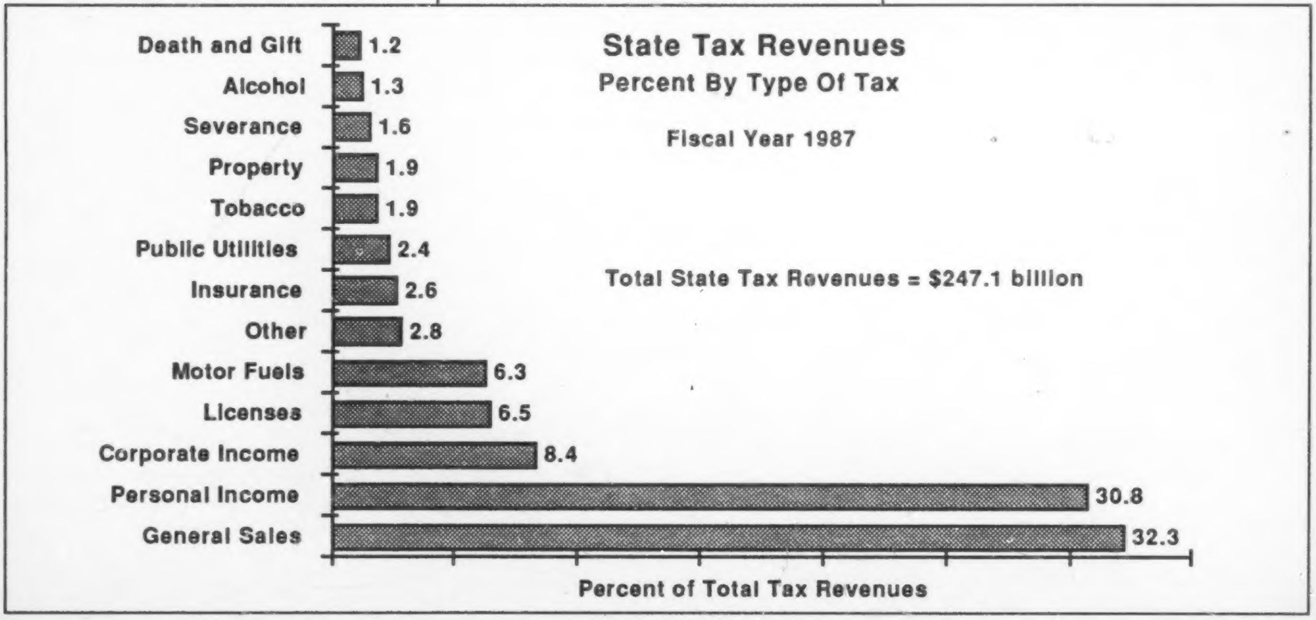
## Gasoline Tax

Gasoline taxes are highest in Montana and Wisconsin (20 cents a gallon), Connecticut and Utah (19 cents) and Hawaii (where combined state-local rates range from 16 to 22.5 cents a gallon). The lowest rate — 4 cents — is levied in Florida, where gasoline is also subject to the general sales tax. The next lowest rate — 8 cents — applies in Alaska, New Jersey, New York, and Wyoming.

## Cigarette Tax

Cigarette Taxes also make a notable contribution to state tax revenues, Tax Foundation economists report. In fiscal 1987, the states collected $4.6 billion, 2% of their total taxes, from tobacco products excises. Rates range from a high of 31 cents a pack in Washington to 2 cents in North Carolina.

The accompanying table gives details, as of April 1, 1988, for major taxes and rates prevailing in the states.



# MAJOR STATE TAXES AND RATES, Reported through April 1, 1988

| State | Income Taxes | | General Sales and Use Tax | Gasoline Tax (per gallon) | Cigarette Tax (per pack of 20) | Property Tax |
|---|---|---|---|---|---|---|
| | Corporate | Individual | | | | |
| Alabama | 5%(F) | 2 to 5%(F) | 4%(a) | 11 cents | 16.5 cents | X |
| Arizona | 2.5 to 10.5(F) | 2 to 8(F) | 5(a) | 16 | 15 | X |
| Arkansas | 1 to 6 | 1 to 7 | 4(a) | 13.5 | 21 | X |
| California | 9.3(q) | 1 to 9.3(q) | 4.75(a) | 9 | 10 | X |
| Colorado | 5.5 to 6(b) | 5(q) | 3(a) | 18(b) | 20 | X |
| Connecticut | 11.5(c) | 1 to 12(d) | 7.5 | 19(e) | 26 | X |
| Georgia | 6 | 1 to 6 | 3(a) | 7.5 + 3% of retail | 12 | X |
| Hawaii | 4.4 to 6.4 | 2.25 to 10(b) | 4 | 15 to 22.5 | 40% wholesale | |
| Idaho | 8 | 2 to 8.2 | 5 | 18 | 18 | X |
| Illinois | 4(p) | 2.5 | 5(a) | 13 | 20 | X |
| Indiana | 3.4(f) | 3.4 | 5 | 15 | 15.5 | X |
| Iowa | 6 to 12(F,h,q) | .5 to 13(F)(q) | 4(a) | 18(e) | 34(b) | |
| Kansas | 4.5(g) | 2 to 9(F) | 4(a) | 11 | 24 | X |
| Kentucky | 3 to 7.25 | 2 to 6(F,r) | 5(a) | 15(i,l) | 3.001 | X |
| Louisiana | 4 to 8(F) | 2 to 6(F) | 4(a) | 16 | 16 | |
| Maine | 3.5 to 8.93(q) | 1 to 10 | 5 | 14 | 28 | X |
| Maryland | 7 | 2 to 5 | 5 | 18.5 | 13 | X |
| Massachusetts | 8.33(j) | 5(k) | 5 | 11 | 26 | X |
| Michigan | 2.35 | 4.6 | 4 | 15 | 25 | X |
| Minnesota | 9.5(q) | 6 to 8(o,q) | 6(a) | 17 | 38 | X |
| Mississippi | 3 to 5 | 3 to 5 | 6 | 17(e) | 18 | X |
| Missouri | 5(F) | 1.5 to 6(F) | 4.225(a,b) | 11 | 13 | X |
| Nebraska | 4.75 to 6.65 | 2 to 5.9 | 4(a) | 17.3(l) | 27 | |
| New Jersey | 9(g) | 2 to 3.5 | 6 | 8(e) | 27 | X |
| New Mexico | 4.8 to 7.6 | 1.8 to 8.5 | 4.75(a) | 14 | 15 | X |
| New York | 9(c) | 3 to 8.375(b,s) | 4(a) | 8 | 21 | |
| North Carolina | 7 | 3 to 7 | 3(a) | 15.8(l) | 2 | X |
| North Dakota | 3 to 10.5(F) | 2.67 to 12(F,m) | 5.5(b) | 17 | 27 | X |
| Ohio | 5.1 to 8.9(c) | .743 to 6.9 | 5(a) | 14.7(l) | 18 | X |
| Oklahoma | 5 | .5 to 6(F,r) | 4(a) | 16 | 23 | |
| Pennsylvania | 8.5 | 2.1 | 6 | 12 | 18 | X |
| Rhode Island | 8(c) | 22.96% of Federal income tax | 6 | 15(i,l) | 25 | X |
| South Carolina | 5.5(b) | 3 to 7 | 5 | 15(e) | 7 | X |
| Tennessee | 6 | 6(d) | 5.5(a) | 17 | 13 | |
| Utah | 5 | 2.75 to 7.75 | 5.094(a,b) | 19 | 23 | X |
| Vermont | 5.5 to 8.25 | 25% of Federal income tax | 4 | 13 | 17 | X |
| Virginia | 6 | 2 to 5.75 | 3.5(a) | 17.5 | 2.5 | X |
| West Virginia | 9.75(b) | 3 to 6.5(q) | 5 | 10.5 | 17 | |
| Wisconsin | 7.9 | 4.9 to 6.93(q) | 5(a) | 20.9(l) | 30 | X |
| Florida | 5.5(q) | | 6(a) | 4 | 24 | X |
| Nevada | These 5 states have no corporate income tax | These 7 states have no individual income tax | 5.75(a) | 14.25(e) | 20(b) | X |
| South Dakota | | | 4(a) | 18 | 23 | |
| Texas | | | 6(a) | 15 | 26 | |
| Washington | | | 6.5(a) | 18 | 31 | X |
| Wyoming | | | 3(a) | 8 | 8 | X |
| Alaska | 1 to 9.4(q) | | These 5 states have no general sales tax | 8 | 16 | X |
| Delaware | 8.7 | 3.2 to 7.7(F,h) | | 16 | 14 | |
| Montana | 6.75(g,t) | 2 to 11(F,n) | | 20 | 16 | X |
| New Hampshire | 8 | 5(d) | | 14 | 17 | X |
| Oregon | 6.6 | 5 to 9(F,h) | | 14(e) | 27 | X |

(X) Indicates state levies a property tax.
(F) Allows Federal income tax as a deduction.

(a) Local taxes are additional.
(b) Future reduction scheduled under current law.
(c) Alternative methods of calculation may be required.
(d) In Connecticut, New Hampshire, and Tennessee, tax applies to income from intangibles only, at various rates according to type. In Connecticut, capital gains are taxed at 7%.
(e) Future increases scheduled under current law.
(f) A supplemental net income tax is imposed at 4.5%.
(g) Corporate surtax imposed: Kansas, 2.25%; Montana, 4%; New Jersey's rate is computed annually.
(h) Deductions limited.
(i) Tax imposed at percent of wholesale value.
(j) A 14% surtax is imposed on the sum of the income tax and a tax on net worth or tangible property not taxed locally.
(k) Tax of 10% on income derived from intangibles, and 5% on all other income.
(l) Tax rate is periodically adjusted administratively.
(m) Optional tax of 14% of taxpayer's adjusted Federal income tax liability.
(n) Additional 10% surtax is imposed for 1987.
(o) Plus 10% of Federal 15% rate and personal exemption phaseout for taxpayers above certain income levels.
(p) Additional 2.5% personal property replacement tax.
(q) Alternative minimum tax is imposed.
(r) Qualified taxpayers may elect to pay alternative taxes at varying rates.
(s) Separate tax is imposed on unearned income through 1988.
(t) 7% rate for corporations using water's edge apportionment.

Source: Compiled by Tax Foundation from data reported by Commerce Clearing House.

(BUDGET WATCH, *from page 3*)

to hold on to its force structure in the face of financial adversity. Fewer "buys" and a lower state of readiness come at a high price, however. Low rates of procurement drive up the cost per plane or tank; fewer flying hours and lower stocks of material leave the country unprepared if international conditions worsen.

The latest (fiscal 1989) budget deviates from the typical defense cutback. While it contains some stretchouts and savings, it adjusts to financial stringency by reducing force levels. Despite his strong support for defense, President Reagan's budget calls for deactivating several air wings, early retirement of ships, and a reduction in the number of military personnel. As a symbol of this retrenchment, the Navy has been compelled to surrender its objective of a 600-ship fleet.

### Stabilizing the Defense Budget

There is widespread agreement that instability leads to inefficiency during both the up and down phases of the defense cycle. Surprisingly, the defense budget appears to be remarkably stable if the time frame is shifted from a single fiscal year to a generation or longer. Over an extended period, real defense rises about 1% a year, less than the growth rate of the economy or the federal budget.

To take advantage of this long-term stability, the Department has urged Congress to budget for defense on a multiyear basis. Thus far, Congress has shown no inclination to abandon annual appropriations, but it has taken a few modest steps to stabilize the defense budget.

In 1986, Congress directed the Pentagon to submit 2-year budgets. Congress has also authorized the Department to write multiyear procurement contracts for designated weapons, and to test an innovation known as "milestone budgeting" which provides for congressional review when predetermined stages in the development or the procurement process are reached. While these innovations help a bit, their application has been limited to only a small part of the defense budget.

Congress likes to keep the Pentagon on a short leash, and to exercise tight control through annual authorizations and appropriations. If it can't get relief from Congress, the Pentagon looks to the Bible for guidance. Remembering Joseph's dream of sevenfat years followed by sevenlean ones, the Department has adjusted to instability and carried on.

## Tax Freedom Day Idea Was the Brainstorm Of a Florida Businessman

Dallas L. Hostetler, Executive Director of the Florida State Retailers Association, devised the idea of Tax Freedom Day in 1948. He was the first to come up with a way to indicate how long Americans had to work for the tax collector before they could begin to work for themselves.

The idea caught on. In 1950, the U.S. House of Representatives and the Senate passed concurrent resolutions resolving that, "Tax Freedom Holiday [as it was then known] be symbolized as a day of relief throughout the land, with such demonstrations as may seem appropriate, including prayer for deliverance." The Freedoms Foundation gave Hostetler its George Washington Honor Medal Award in 1950.

Hostetler retired in 1974, at the age of 72, and assigned the Tax Freedom Day concept to the Tax Foundation. The Foundation's economists were delighted to accept the offer, and to receive transmittal of the idea which Hostetler had registered with the U.S. Copyright Office in 1953.

It has turned out to be one of the most widely known information releases produced by the Foundation.

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# *State Tax and Fiscal Prospects, 1988*

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State legislatures this year face an extensive array of tax proposals, following a near-record volume of legislation in 1987. At least 28 of the 44 states holding regular sessions in 1988 will consider changes in one or more major taxes. (No legislative sessions are being held in Arkansas, Montana, Nevada, North Dakota, Oregon, and Texas.)

According to a Tax Foundation survey as of Mid-March, 22 states will seek higher taxes, with potential revenues totaling more than $4 billion annually. Six other states are weighing reductions, generally in small amounts adding up to under $200 million. The prospects for enactment of the bills pending, as well as potential revenue effects, are difficult to predict. It is an election year, when state officials are reluctant to impose higher taxes on their constituents; many proposals are somewhat nebulous; some require voter approval; and others lack strong legislative backing.

Deliberations in 1988 follow a year in which nearly all states with income taxes reexamined their tax structures vis-a-vis possible revenue changes that would automatically result from the 1986 revision of the Federal tax code. In addition, many states looked at nonincome taxes for new revenues. Altogether, 28 states last year sought to raise close to $8 billion annually in new revenue to balance ongoing budgets and pay for growing spending programs. It is estimated that $6 billion in higher taxes was enacted.

The 1988 tax increases are sought primarily to meet rising costs of improved local school programs; to finance continuing highway construction, maintenance, and repair; to strengthen medical care funding; and to balance generally rising budgets.

The most popular targets for new revenues this year are levies on motor fuels (increases are pending in 11 states), general sales (10 states), personal income (6 states), business profits (6 states), cigarettes (5 states), and alcoholic beverages (3 states).

The changes under consideration, by type of tax, are summarized below, followed by a state-by-state summary of proposed revisions.

General Sales Taxes. Ten states are weighing increases in general sales taxes, and three are considering slight reductions. Sales tax rate increases have been proposed in Michigan (sponsored by education groups for more equitable school financing), Missouri (for medical care), North Carolina (for local public school buildings), and West Virginia (for general budget balancing). Base-broadening measures extending the sales tax to cover items previously exempt, mostly some services, are being considered in Arizona, Colorado, Idaho, Louisiana (one proposal would remove *all* sales tax exemptions), Washington, and Wisconsin. Most base-broadening proposals involve extending the tax to a limited number of items. Florida's unsuccessful 1987 experience in attempting to expand the tax to cover a comprehensive range of services appears to have discouraged efforts in other states to gain large new sums from increasing the variety of items taxed.

In three states, proposals call for slight reductions in the sales tax. Some lawmakers in Connecticut have asked for the exemption of clothing items costing less than $100, as well as a rate reduction; the governor of Kansas wants to exempt new manufacturing machinery and equipment; and South Dakota repealed a one-cent temporary hike in the sales tax two months early.

Personal Income Taxes. Thirteen states are considering personal income tax revision this year. Six states are looking for new revenues from the changes; three states may reduce income taxes; and in four states the revisions would be neutral.

Increases in personal income taxes are pending in Alabama, Illinois, Kentucky, Massachusetts, Missouri, and Wisconsin. Some legislative leaders in Alabama want to raise income taxes to gain an additional $304 million for higher state spending. Illinois' governor has indicated strong support for income tax increases to support a more generous state budget. In Kentucky, where the legislature did not meet in 1987, some lawmakers want to conform the state tax to the new Federal code in order to gain new state revenue. Massachusetts lawmakers will also consider conformity to the Federal law, to raise $74 million in new revenue. Missouri is expected to consider 7 1/2% surcharges on income taxes; and some Wisconsin legislators seek repeal of the state's 60% capital gains exclusion that was retained last year in a comprehensive tax revision.

Personal income tax reductions are pending in Kansas, Oklahoma, and Vermont. Kansas may return all or part of the "windfall" resulting from Federal tax revision. Oklahoma may restore the extra personal exemption for the low-income elderly, along with cutting the top marginal rate for those who deduct Federal taxes in computing state tax liability. The governor of Vermont recommended a temporary cut in the tax rate, as well as an earned income tax

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credit.

**Business Taxes.** At least ten states are deliberating changes in business income taxes. Proposals in six states would result in higher taxes: Idaho (repeal of the investment tax credit), Illinois (rate increase); Louisiana (broaden base), Missouri (7 1/2% surcharge); South Dakota (impose a corporate tax); and Wisconsin (tax unrelated business income of tax-exempt organizations).

On the other hand, business tax reductions may be made in four states: Michigan and New Hampshire may ease business profits taxes; proposals in Pennsylvania would lower the capital stock and franchise tax and the utility gross receipts tax; and Rhode Island has already approved repeal of its corporate net worth tax.

**Motor Fuels Taxes.** Higher motor fuels taxes, primarily to support highway needs, continue to be a major target for legislation in states where rates are not administratively determined. Eleven states are expected to consider hikes in motor fuels taxes in 1988. Increases have already been enacted in Indiana and South Dakota. Other states include: Colorado, Idaho,Iowa, Maine, Minnesota, Vermont, Washington, West Virginia, and Wisconsin.

**Other Taxes.** Relatively few changes are under consideration for cigarette and alcoholic beverage taxes. Five states may raise cigarette tax rates: Iowa, Louisiana, Rhode Island, West Virginia, and Wyoming. Increases in some alcoholic beverage products are being discussed in Hawaii, Iowa, and Wyoming.

Apart from their consideration of state tax changes, the legislatures in four states have on their agenda the comprehensive statewide reform of local property taxes. The reforms generally seek greater equity among types of taxpayers, as well as reduction of local property tax burdens. States considering such revisions are Minnesota, Oklahoma, Wisconsin, and Wyoming.

## Selected State Reports

**Alabama.** Legislative issues this year are focused on ways to increase funding for schools. The governor presented a balanced budget, asking for no tax increases, but for transfers of some earmarked funds to the general fund (88% of Alabama's revenues are dedicated to specific functions). He said that in 1989 the state should tackle tax reform, but "this year education should require our attention." On the other hand, the speaker of the house holds that tax revenues must be increased this year to meet education needs, and is seeking a $307 million state tax increase through revisions in the personal income tax.

**Arizona.** In his state of the state address, the governor said that he would not support any tax rate increases; several weeks later, however, he proposed a $93.9 million revenue increase to balance the budget for fiscal 1989. Under consideration in the legislature are broadening the sales tax base and reforming the personal income tax.

**Colorado.** Although the governor has proposed close to $1 billion in higher taxes, the legislature is reportedly not receiving these recommendation with favor. Among the governor's tax proposals are broadening the sales tax base, increasing the gasoline tax, and raising registration fees.

**Connecticut.** The governor recommended no tax increases or reductions. Some legislative leaders, however, have proposed repealing the two-cent gasoline tax increase approved last year and exempting articles of clothing priced at $100 or less from the 7.5% sales tax. Another proposal would cut the sales tax rate to 7%.

**Florida.** No significant tax changes are expected in Florida this year.

**Hawaii.** The legislature may consider increasing alcoholic beverage tax rates and a new conveyance tax, the latter as part of the governor's initiative to establish a housing fund for rental assistance. The outlook for passage is said to be tenuous. The governor is opposing attempts to return the state's $400 million budget surplus to the taxpayers; instead, he wants to use the funds to finance several new state programs, including housing.

**Idaho.** The governor proposed several tax increase measures, including repeal of the investment tax credit, raising motor fuels tax rates, broadening the sales tax base by eliminating the trade-in exemption and extending the tax to auto and other repair services, and establishing a flat 3% insurance tax. The legislature is reportedly unwilling to approve any of the proposals, except perhaps the motor fuels tax increase.

**Indiana.** The legislature adjourned February 29, after enacting an increase in the gasoline tax and authorizing the state to issue highway bonds for the first time. Lawmakers also raised the diesel fuel tax and increased a truck fuel surcharge, to replace a truck tax that had been ruled unconstitutional. Because of recent, unexplained, declines in revenue collections, there is speculation that the 1989 surplus will be substantially lower than previously estimated, and there is a strong likelihood of pressure for tax increases or budget cuts in the 1989 session.

**Iowa.** The legislature is considering tax increases to avoid a potential $150 million budget deficit. Under consideration are proposals to tax wine coolers at $1.75 a gallon and to raise motor fuels tax rates. Lawmakers have already approved an increase in the cigarette tax from 26 cents to 34 cents a pack. Opinion in the legislature is divided as to whether to make permanent the temporary (one-year) income tax code changes enacted last year, or to simply extend the 1987 changes for one more year.

**Kansas.** Instead of continuing to retain the "windfall" revenues from Federal tax revision, as the state did in 1987, the governor asked for revision of the personal income tax so as to return about 40% of the "windfall". He also proposed major reforms in the business tax code, including exempting purchases of new manufacturing machinery and equipment from the sales tax, and changing the method of taxing multinational corporations headquartered in Kansas. Although lawmakers reportedly were generally receptive to the governor's plan, the senate majority leader proposed returning to the taxpayers all of the "windfall" gain.

Kentucky. The governor said that his budget would require no additional taxes. Many lawmakers, however, prefer to raise taxes rather than cut spending, and would like to revise the state income tax to gain revenue by conforming to the new Federal tax code. Lawmakers did not convene in 1987, and this year represents their first opportunity to consider Federal conformity. (The governor is said to be adamantly opposed to income tax conformity.)

Louisiana. The new governor has called a special session of the legislature for March 21 to consider the state's acute financial situation (the regular session convenes April 18.) Numerous proposals for tax changes have surfaced, designed to raise new revenues and to reform the state's tax system. Some suggestions would remove all sales tax exemptions (for new revenue of $450 million), raise the tobacco tax, impose a flat 4% rate on personal income, and broaden the base of personal and corporate income taxes. The budget deficit in 1988 is estimated at $330 million, and follows accumulated deficits in the two prior years totaling $445 million. Based on financing current programs and revenue projections, there would be a $700 million deficit for fiscal 1989. (Louisiana's constitution requires that the legislature enact a balanced budget, but not that the state end with one.)

Maine. The governor asked for a 5-cent increase in the gasoline tax, along with reform of the income tax system by broadening the tax base, simplifying the bracket structure, and reducing rates. He also recommended tax rebates totaling $17 million to compensate taxpayers for a windfall of higher state taxes in the last half of 1987 resulting from Federal tax changes.

Massachusetts. To circumvent potential deficits in both fiscal 1988 and 1989, lawmakers are expected to consider measures to add $264 million to 1989 tax collections. One of the proposals would conform the state income tax to the new Federal income tax code, to raise an estimated $74 million. Minor technical changes in tax laws, along with more enforcement resources, account for the rest of the revenue-raising package. Another major issue before the Massachusetts legislature, a carry-over from 1987, is health care financing, including a proposal to provide universal health insurance.

Michigan. The governor proposed closing various tax loopholes and reducing the property tax burden. Last year, the legislature revised the personal income tax to return the "windfall" from Federal tax revision to taxpayers; this year consideration may be given to cutting some business taxes. Legislation already enacted this year will exempt from personal income tax those earning less than $1,500 a year (the law will primarily affect children, who became subject to tax when Michigan adopted the new Federal code). There are proposals in Michigan, backed primarily by school groups, to raise the sales tax to gain an additional $700 million to $1,400 million, earmarked for public education. (Such a change would require a popular vote, because the sales tax rate is set in the constitution.) The sales tax increase proposal is an attempt to deal with per pupil disparities among local school districts and the high reliance on property taxes to fund public education.

Minnesota. Last year, the state concentrated on income tax revision; this year the major issue before the legislature is revision and reform of property taxes. The governor proposed measure that would cut property taxes for commercial and industrial property, give tax relief to high-tax cities, increase local government aid, and simplify the state's classified property system by reducing the number of property classes from 68 to 4. The administration hopes to pay for the reforms, which would cost an estimated $200 million over two years, by relying on new revenues from economic growth. The legislature is also considering an increase in the state gasoline tax.

Mississippi. No legislative tax changes are expected. The governor proposed a $198.7 million spending increase for education, to be paid for by a combination of new revenue growth, budget cuts, bond programs, and surplus cash reserves.

Missouri. Tax proposals include raising the sales tax by 3/8%; and imposing 7 1/2% surcharges on personal and corporate income taxes, for new money of $150 million and $75 million, respectively. These and other increases are sought to provide a portion of the funding for a proposed "medassist" plan. In addition, more than 80 bills have been introduced that would affect taxes in some way.

Montana. No legislative session is to be held in 1988.

Nebraska. Stating that the condition of the state is "measurably improved" in the last 12 months, the governor outlined new education funding and other spending plans, and stressed that she believed it vital to avoid new taxes. She also suggested a study to determine a "constitutional and equitable" formula for evaluating farm land values for tax purposes. Doubts have been expressed by some legislators as to whether the governor's spending plan exceeds available revenue in the second half of the current biennium.

New Hampshire. Some lawmakers are seeking a reduction in the business profits tax from 8% to 7 1/2% or 7%. (A similar proposal failed to pass last year.)

New Jersey. The governor proposed that the state sponsor a foreign sales corporation so that the state's small- and medium-sized businesses could qualify for Federal tax breaks. (On January 19, 1988, the governor signed a bill raising state motor fuels taxes, passed by the 1987 legislature.)

New York. The governor proposed no new taxes, but suggested some revisions in sales taxes and estate and gift taxes, as well as the imposition of a new solid waste disposal fee to help close municipal landfills. He also stressed the importance, in his view, of adhering to tax cuts previously enacted.

**North Carolina.** The legislature will convene June 2, in what is expected to be a short budget session. Among tax measures to be considered, carried over from 1987, is an increase in the state sales tax by 1%, with proceeds earmarked for public school buildings.

**Ohio.** The governor did not propose any tax changes in this "off-year" legislative session, and no major tax changes are anticipated. Legislative leaders have predicted that higher taxes will be enacted next year.

**Oklahoma.** The governor suggested changes in the personal income tax, in addition to those made last year. He would restore a $1,000 exemption for the elderly that was dropped in 1987 (but would limit it to lower-income taxpayers) and would reduce the tax rate for those who deduct Federal taxes in computing state tax liability. The legislature is expected to consider revamping the ad valorem tax system to allow assessments at 100% of market value, instead of 55% as at present, and to remove millage caps in the constitution. Lawmakers may also consider a flat 2% tax on casualty insurance gross premiums, which would raise about $7 million.

**Oregon.** The legislature is not meeting this year. A voter-instigated initiative to make the present statutory spending limitation constitutional is under way, and may appear on the November 1988 ballot.Pennsylvania. The governor said in his budget address that he will not support any increases in state taxes. Last fall, however, he presented a bill to a special session of the legislature that would substantially liberalize the authority of local governments to impose income taxes. Some legislative leaders are seeking reductions in two business taxes, totaling $98 million annually; they would cut the rate of the capital stock and franchise tax and the utility gross receipts tax.

**Rhode Island.** The governor asked that the state continue to review the possibilities of reducing or eliminating certain taxes, and that continued cuts be made in the state income tax. (His proposal to eliminate the corporate net worth tax was subsequently approved by the legislature.) Later in the session the governor asked the legislature to raise the cigarette tax by one cent, to provide new money for a drug prevention and rehabilitation program.

**South Carolina.** The governor proposed no tax increases. He suggested that, in view of the state's relatively high industrial property tax rates, local governments be given the authority to negotiate fees in lieu of property taxes. He also urged restoration of the capital gains differential in income tax rates. A separate tax proposal would authorize 1% (optional) county sales taxes, with 100% of the proceeds dedicated to county property tax reductions.

**South Dakota.** The governor proposed, and the legislature approved, the early phase-out of a one-cent sales tax increase enacted last year. The extra tax was repealed effective March 1, two months earlier than scheduled. Farm groups have urged the imposition of a corporate income tax in South Dakota (one of five states without such a tax), with the proceeds dedicated to relieving property taxes and raising teachers' salaries. In addition, an increase in the motor fuels tax rate from 13 cents to 18 cents a gallon, has been approved in the 1988 session.

**Tennessee.** The governor recommended an increase in property tax exemptions for low-income elderly homeowners. He requested no higher taxes.

**Texas.** The legislature is not convening in 1988.

**Vermont.** The governor recommended a temporary reduction in the personal income tax, from 25% to 24% of Federal tax liability and the enactment of an earned income tax credit. She also proposed a two-cent increase in the gasoline tax, higher vehicle registration fees, and a weight/distance tax for trucks, excluding milk trucks.

**Washington.** The legislature held a short, nonbudget, session to consider the governor's supplemental requests for the rest of the current biennium. Lawmakers approved broadening the sales tax base to include prepared food at grocery stores (for $8.1 million in new revenues), and considered increasing the gasoline tax in two steps for $110 million in the first year and $162 million in the second year.

**West Virginia.** The governor asked for about $97 million in higher taxes through increases in the cigarette and gasoline taxes, along with a new tax on smokeless tobacco. Opposing legislative leaders advanced alternative plans, including a 1% increase in the state sales tax. The budget for fiscal 1989 is frozen at just under $1.5 billion, or $23 million less than the fiscal 1988 budget.

**Wisconsin.** The governor proposed a wide-ranging plan for property tax relief, to be financed by new state funds from broadening the sales tax base, adjusting the married couple's income tax credit to reflect last year's tax reductions, imposing a tax on the unrelated income of tax-exempt organizations, taxing commercial rents, and using state lottery proceeds. The governor's plan would raise an additional $245 million in 1988-89 and $318 million in 1989-90 for the state. He would also give municipalities the authority to adopt "leisure" taxes of up to 3%. The legislature is also expected to consider raising the motor fuels tax, to generate an extra $21 million a year. In addition, some legislators are pushing for repeal of the 60% exclusion of capital gains from the income tax base and the use of the proceeds for property tax relief.

**Wyoming.** The governor urged the legislature to support a classified property tax system, to replace the current system, which was declared unconstitutional by the state supreme court. To help balance the forthcoming budget, the governor has proposed higher taxes on cigarettes and malt beverages, and the temporary diversion of some severance taxes to the general fund.

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# TAX·FEATURES

# Typical Two-Earner Family Increased Purchasing Power Since '80

## *Top 50 Percent of Earners Pay 93.8 Percent of Federal Individual Income Tax Burden; Top Ten Percent Pays Over Half*

The top earning half of the population continues to pay well over 90 percent of the Federal individual income tax bill, according to Tax Foundation analysis of preliminary IRS data for 1986. In fact, despite all the major tax legislation of the past decade, this group's share of the tax burden has varied within the narrow range of 92.6 to 94.0 percent of total taxes paid, and was 93.8 percent in 1986.

The system remains progressive as the top ten percent of earners continue to shoulder a significantly larger share of the tax burden, up from 49.5 percent in 1979 to 55.5 percent in 1986, a six percent increase.

This growth in tax burdens has occurred despite the alleged upper-income bias of the rate reductions and other tax cuts under the Economic Recovery Tax Act of 1981 (ERTA). The Treasury Department reported that for the 1981-1986 period taxpayers with adjusted gross incomes exceeding $100,000 paid $72 billion more in 1986 than in 1981 while persons with adjusted gross incomes under $50,000 received a net tax cut of $18 billion between 1981 and 1986.

Growth in the income base itself has been increasing faster at the upper end of the income scale, resulting in increased tax receipts from top earners. Specifically, the increase in capital gains taxes accounted for the bulk of the tax revenue rise in 1986. The jump in the top tax rate on capital gains from 20 percent to 28 percent beginning January 1, 1987 under the Tax Reform Act of 1986 caused an extraordinary level of capital gains realization before the increase kicked in. Taxable net gains in 1986 rose 99.6 percent to $135 billion, accounting for 25 percent of income to earners in the top income brackets and fueling a 9.4 percent jump in total adjusted gross income to $2.52 trillion.

In 1986, the top five percent of earners paid an average tax of $31,309, up 80 percent from 1979. The

*(Continued on page 6)*

Increased earnings, slower inflation and Federal individual tax cuts have boosted the U.S. family's purchasing power since 1980, according to Tax Foundation analysis. Since approximately 60 percent of married-couple families now include a wife in the paid labor force, the Tax Foundation has replaced the one-earner family analysis with the more realistic two-earner household. A typical family—a household with two earners employed full-time, year-round with two dependent children—realized an increase in real income of $3,714 since 1980 after adjusting for direct Federal taxes.

The two-earner median family's nominal income has risen consistently since 1980, averaging approximately a six percent increase each year. The two-earner family making $29,627 in 1980 is now making an estimated $46,848. However, when direct Federal taxes and inflation are taken into account, the $17,221 increase in this family's income between 1980 and 1988 resulted in only a $3,714 net gain. Over 78 percent of increased income has been eroded by direct

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### Median Family Income Before and After Direct Federal Taxes and Inflation
### 1980-1988

| Year | Two-Earner Median Family Income[a] | Direct Federal Taxes | | | After-Tax Income | |
|---|---|---|---|---|---|---|
| | | Income Tax[b] | Social Security | Total | Current Dollars | 1988 Dollars[c] |
| 1980 | $29,627 | $4,050 | $1,816 | $5,866 | $23,761 | $33,993 |
| 1981 | 32,224 | 4,386 | 2,143 | 6,529 | 25,695 | 33,327 |
| 1982 | 34,515 | 4,450 | 2,313 | 6,763 | 27,752 | 33,927 |
| 1983 | 36,106 | 4,300 | 2,419 | 6,719 | 29,387 | 34,778 |
| 1984 | 38,713 | 4,634 | 2,710 | 7,344 | 31,369 | 35,606 |
| 1985 | 40,593 | 4,787 | 2,862 | 7,649 | 32,944 | 36,083 |
| 1986 | 42,492 | 5,158 | 3,038 | 8,196 | 34,296 | 36,877 |
| 1987[d] | 44,617 | 5,319 | 3,190 | 8,509 | 36,108 | 37,456 |
| 1988[d] | 46,848 | 5,623 | 3,518 | 9,141 | 37,707 | 37,707 |

[a] Median income for household with two earners employed full-time, year round.
[b] Married couple filing joint return, two dependent children.
[c] Adjusted by Consumer Price Index, assumes 3.8% inflation in 1988.
[d] Estimated by Tax Foundation.

Source: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Treasury Department, Internal Revenue Service.

# Federal Grants Drop 4.5%; FL, TX Pay Highest Aid Premiums

Federal grants-in-aid to state and local governments dropped 4.5 percent in FY87 (latest available) to $102.9 billion, according to Tax Foundation economists. This was their first decline since 1982. They had been averaging six percent increases over the last four years. With FY87's 4.5 percent decline, the pace of Federal grant giving has continued its sharp slowdown since 1981. After growing at annual rates averaging 15 percent during the 1970s, growth in Federal grants has averaged 2.3 percent since 1980.

## Federal Grants-In-Aid To State and Local Governments and Estimated Federal Tax Burden for Grants

### Fiscal Year 1987

| State | Grants[a] ($Millions) | Percent of Total Tax Burden | Tax Burden per Dollar of Aid | Estimated Tax Burden for Grants[b] ($Millions) Amount | Rank |
|---|---|---|---|---|---|
| Total | $102,934.5 | 100.00% | $102,934.5 | $1.00 | - |
| Alabama | 1,510.3 | 1.23 | 1,266.1 | .84 | 32 |
| Alaska | 605.4 | .29 | 298.5 | .49 | 50 |
| Arizona | 1,172.7 | 1.23 | 1,266.1 | 1.08 | 12 |
| Arkansas | 1,000.8 | .68 | 700.0 | .70 | 38 |
| California | 10,909.9 | 12.59 | 12,959.5 | 1.19 | 10 |
| Colorado | 1,105.7 | 1.36 | 1,399.9 | 1.27 | 6 |
| Connecticut | 1,489.0 | 1.97 | 2,027.8 | 1.36 | 4 |
| Delaware | 301.4 | .30 | 308.8 | 1.02 | 17 |
| Florida | 3,151.0 | 4.91 | 5,054.1 | 1.60 | 1 |
| Georgia | 2,507.2 | 2.26 | 2,326.3 | .93 | 27 |
| Hawaii | 459.7 | .42 | 432.3 | .94 | 25 |
| Idaho | 372.0 | .30 | 308.8 | .83 | 33 |
| Illinois | 4,466.8 | 5.28 | 5,434.9 | 1.22 | 8 |
| Indiana | 1,981.6 | 2.00 | 2,058.7 | 1.04 | 14 |
| Iowa | 1,089.6 | .99 | 1,019.1 | .94 | 26 |
| Kansas | 845.3 | 1.00 | 1,029.3 | 1.22 | 7 |
| Kentucky | 1,687.0 | 1.10 | 1,132.3 | .67 | 41 |
| Louisiana | 1,914.1 | 1.39 | 1,430.8 | .75 | 37 |
| Maine | 688.8 | .39 | 401.4 | .58 | 45 |
| Maryland | 2,254.1 | 2.21 | 2,274.9 | 1.01 | 18 |
| Massachusetts | 2,983.3 | 2.99 | 3,077.7 | 1.03 | 15 |
| Michigan | 4,196.2 | 3.97 | 4,086.5 | .97 | 21 |
| Minnesota | 2,034.9 | 1.74 | 1,791.1 | .88 | 29 |
| Mississippi | 1,253.3 | .64 | 658.8 | .53 | 48 |
| Missouri | 1,923.0 | 1.96 | 2,017.5 | 1.05 | 13 |
| Montana | 496.4 | .26 | 267.6 | .54 | 47 |
| Nebraska | 606.2 | .57 | 586.7 | .97 | 22 |
| Nevada | 382.2 | .43 | 442.6 | 1.16 | 11 |
| New Hampshire | 386.1 | .49 | 504.4 | 1.30 | 5 |
| New Jersey | 3,326.9 | 4.44 | 4,570.3 | 1.37 | 3 |
| New Mexico | 690.8 | .46 | 473.5 | .69 | 39 |
| New York | 11,932.0 | 8.75 | 9,006.8 | .75 | 36 |
| North Carolina | 2,168.3 | 2.16 | 2,223.4 | 1.03 | 16 |
| North Dakota | 404.8 | .23 | 236.7 | .58 | 44 |
| Ohio | 4,381.3 | 4.25 | 4,374.7 | 1.00 | 19 |
| Oklahoma | 1,313.2 | 1.15 | 1,183.7 | .90 | 28 |
| Oregon | 1,032.8 | .97 | 998.5 | .97 | 23 |
| Pennsylvania | 5,267.6 | 4.82 | 4,961.4 | .94 | 24 |
| Rhode Island | 549.9 | .41 | 422.0 | .77 | 35 |
| South Carolina | 1,276.7 | 1.02 | 1,049.9 | .82 | 34 |
| South Dakota | 436.0 | .21 | 216.2 | .50 | 49 |
| Tennessee | 1,890.8 | 1.60 | 1,647.0 | .87 | 30 |
| Texas | 4,846.4 | 6.65 | 6,845.1 | 1.41 | 2 |
| Utah | 748.6 | .47 | 483.8 | .65 | 42 |
| Vermont | 313.5 | .19 | 195.6 | .62 | 43 |
| Virginia | 2,143.6 | 2.48 | 2,552.8 | 1.19 | 9 |
| Washington | 1,944.5 | 1.88 | 1,935.2 | 1.00 | 20 |
| West Virginia | 1,026.3 | .54 | 555.8 | .54 | 46 |
| Wisconsin | 2,154.2 | 1.82 | 1,873.4 | .87 | 31 |
| Wyoming | 287.7 | .19 | 195.6 | .68 | 40 |
| District of Columbia | 1,024.4 | .36 | 370.6 | .36 | 51 |

[a] Excludes shared revenues and payments in lieu of taxes; includes general revenue sharing and trust fund aid.

[b] The tax burden for grants is assumed to equal grant payments.

Source: Tax Foundation computations based on data from the Treasury Department and U.S. Department of Commerce, Bureau of the Census.

## The Big Four

Twenty-five programs account for more than 85 percent of total grant disbursement. Of these, the largest four are medicaid - $27.2 billion, highways - $11.2 billion, Aid to Families with Dependent Children (A.F.D.C.) - $10.5 billion, and housing assistance at $5.8 billion. These four programs alone accounted for over 53 percent of all grants disbursed in fiscal 1987. While highway assistance was reduced sharply by 14.8 percent from FY86 to FY87, A.F.D.C. and housing assistance showed sizeable increases of 12.6 percent and 9.7 percent respectively. In 1987 there were approximately 372 different grant-in-aid programs, but most of the spending was concentrated in a few areas.

Most of FY87s $4.9 billion reduction in Federal grants was the result of elimination or consolidation of smaller programs where the benefits were primarily local rather than national, such as economic development and the construction and operation of local transportation systems.

## Winners and Losers

Tax Foundation analysis of the grant-in-aid programs determines where Federal grant revenue is raised and where it is disbursed on a state-by-state basis. In terms of their Federal

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**Tax Features**

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*Budget Watch* By Allen Schick

# Tax Expenditures: Myths and Realities

Tax expenditures are among the most controversial and confusing features of the Federal budget. The concept appears to be simple; applying it to the numerous provisions in the tax code is not. The term refers to deviations from the "normal" tax structure that give preferential treatment to particular activities or groups of activities and result in a loss of Federal revenues. The term recognizes that these preferences have the same subsidy effects as direct expenditures: they provide financial benefits to recipients and they cost the Treasury money. Tax expenditures were officially defined in the Congressional Budget Act of 1974. Before then, they were called loopholes; they still are.

The tax code is complex and the concept is often used for political advantage; hence, there are serious misunderstandings about tax expenditures. This article examines four myths about tax expenditures; (1) it is just as easy to define and measure them as direct spending; (2) most tax expenditures go to business; (3) among individuals, high income persons are the main beneficiaries; and (4) the steady rise in the amount of tax expenditures is due to recent legislation establishing new loopholes. None of these claims is warranted by the facts.

### Myth No. 1

### It is easy to define and measure tax expenditures.

The definition of tax expenditures is inherently ambiguous. A provision of the tax code deemed to be a preference by some experts might be regarded as an essential feature of the tax system by others. The list of tax expenditures published by Congress' Joint Committee on Taxation (JCT) in March 1988 contains 28 items not included in the analysis issued only one month earlier by the President's Office of Management and Budget (OMB).

Some of the confusion results from applying a double standard to tax expenditures. The tax code has provisions which are virtually identical, but some are regarded as part of the normal rate structure while others are labelled as preferences. The tax rates levied on corporate and individual incomes are a case in point. With the implementation of the Tax Reform Act of 1986 (TRA'86), both types of income now have a two-rate structure. Individual income is taxed at 15 percent and 28 percent; corporations pay a reduced rate on the first $75,000 of income, and 34 percent on income above that amount. One can argue either that differential rates are a normal feature of a graduated tax structure or that they provide a preference for low-income persons and firms. However, Congress' tax mavens have decided to treat the lower individual and corporate rates differently. They list the lower corporate rate as a tax expenditure, but treat the lower individual rate as part of the tax structure. This double standard demonstrates how the measurement of tax expenditures is colored by subjectivity.

> ***Before the Budget Act of 1974, tax expenditures were called loopholes; they still are.***

By no means is this the only dubious application of the tax expenditure concept. A brand new one has just entered the official list, thanks to the TRA'86 limitation on the extent to which passive losses can be used to offset other income and thereby lower an investor's tax liability. The concept of a normal tax structure is that all income should be treated alike for purposes of taxation. It would seem that just as a tax structure has some preferences which are classified as tax expenditures, it might also treat some income less favorably, and these instances might be regarded as "negative tax expenditures" because they increase tax liabilities and Federal revenues above normal levels. This situation would seem to apply to taxpayers who have passive losses. Some passive losses (for example, for rehabilitation of structures and low-income housing) are exempted from the special tax rules. As a result, income from these sources is taxed at the normal level. But the JCT tax experts have decided that these exemptions constitute tax expenditures, despite the fact that taxpayers pay the same taxes as they would on active income. This convoluted logic isn't fair, doesn't make sense, and demonstrates the difficulty of defining and measuring tax expenditures.

### Myth No. 2

### Business gets most tax breaks.

Judging from the newspapers, it would appear that the biggest loopholes benefit big business. The facts prove otherwise, but myths often persist in the face of facts to the contrary.

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The official list of tax expenditures distinguishes between those benefit-

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ting corporations and those provided to individual taxpayers. For various reasons, it is not correct to add up all tax expenditures as if they were independent from one another. Tax expenditures interact with one another and with other provisions of the tax code, so that the total can be either greater or less than the sum of individual preferences. Nevertheless, adding up tax expenditures shows the enormous disparity between the value of the preferences going to individuals and corporations.

JCT estimates that tax expenditures will approach $300 billion in the 1989 fiscal year. But only 12 percent of these benefits, or $37 billion, are provided to corporations; approximately $160 billion goes to individuals. OMB, which has a narrower definition of tax expenditures, reports even fewer preferences going to corporations.

## Myth No. 3

### Wealthy persons get most tax expenditures.

It is widely taken for granted that most tax breaks go to upper-income persons. In fact, however, the overall bulk of the individual tax breaks go to the middle class. The following five preferences account for more than half of all the tax expenditures projected to benefit individuals in fiscal 1989:

| Preference | Billions of Dollars |
|---|---|
| Exclusion of pension contributions and earnings | $45.6 |
| Deduction of mortgage interest on homes | 30.8 |
| Exclusion of employer payments for medical insurance and care | 27.6 |
| Deduction of state-local property and income taxes | 24.5 |
| Exclusion of social security benefits | 18.0 |

These exemptions and deductions are costly and popular because they benefit many millions of Americans. With the exception of social security payments and medicare, they are the biggest middle class subsidies in the Federal budget.

There is a significant relationship between wealth and income on the one hand and tax expenditures on the other. Tax expenditures are a function of tax liability. The higher a person's tax bracket, the greater the value of the tax preferences that he or she is likely to receive. The millions of persons removed from the tax rolls by TRA'86 have no tax expenditures (except for those who receive the earned income credit) because they do not pay any taxes. Conversely, those who have had high tax liabilities generally also have had high tax expenditures through itemized deductions and other provisions.

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However, by reducing marginal tax rates, TRA'86 significantly reduced the value of major tax expenditures for all income groups. According to CBO estimates, the dollar value of the five tax expenditures listed above will be more than $40 billion lower in 1991 than it would have been if marginal tax rates had not been changed by the 1986 law. Both before and after TRA'86 the distribution of tax expenditures has been roughly proportional to taxes paid. A $150,000 income earner is likely to pay substantially more income taxes and at the same time enjoy more tax expenditures than the more typical $35,000 income earner. But because there are so many more of the latter, the overall dollar value of individual tax expenditures is concentrated among the middle-income groups.

## Myth No. 4

### Tax expenditures have been rising because Congress has enacted new preferences.

The value of tax expenditures has steadily increased over the dozen or so years that comparable data have been available. The usual explanation is that Congress has established new tax expenditures. The real reason is that as tax burdens have escalated, the value of old tax expenditures has also increased. The table below classifies fiscal 1989 tax expenditures by the period in which they were first enacted or recognized by the IRS or other authorities. The list is not complete because the date of origin of a few tax expenditures has not been determined. The pattern, however, is remarkable. Legislation enacted since 1960 accounts for only a small portion of tax preferences. The largest amounts derive from legislation enacted (or rulings issued) about the time the income tax was introduced. Other major expansions occurred during the World War II period when tax rates were substantially increased.

*. . . the overall bulk of the individual tax breaks go to the middle class. . . . These exemptions and deductions are costly and popular because they benefit many millions of Americans.*

| Period During Which Tax Expenditure Was First Enacted or Authorized by Regulation | Estimated Fiscal Year 1989 Value ($billions) |
|---|---|
| 1920 or Earlier | $102 |
| 1921 – 1940 | 56 |
| 1941 – 1960 | 94 |
| 1961 – 1980 | 21 |
| Since 1980 | 4 |

To sum up, high tax expenditures are associated with high tax burdens. The best way to significantly lower tax preferences is to reduce rates and liabilities. This isn't myth; it's a fact.

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FEDERAL TAX POLICY MEMO

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# The Future of Social Security Financing

## Summary

(I) The old age and disability trust funds currently are building large surpluses. However, the social insurance system as a whole, including the hospital insurance component, could experience operating deficits by the turn of the century, only eleven years ahead. Without reforms, deficits are likely to become large by 2020 and overwhelming by mid-century.

(II) Political opposition to changes in the benefit structure and financing of social security is strong but not totally unyielding. Changes that would put the system on a sound financial footing and target the transfer or welfare element more effectively can be made gradually without destroying support for the system. These changes should encourage middle- and upper-income retirees/beneficiaries to rely more on private sector arrangements but preserve the payroll tax-financed basic system for all workers.

(III) To ease the Federal deficit problem now, inflation indexing of social security benefits could be limited to that increase in the consumer price index above a 2 percent floor. This restraint should be applied for a period of 5 years to the personal tax structure as well as to social security and other entitlement programs.

(IV) For the longer term, consideration should be given to a two-tier benefit structure: the first tier assuring a minimum level of support for low- and modest-income retirees financed by general revenues; and the second tier as an annuity program for all workers based solely on payroll tax contributions. Public subsidy would be limited to the first tier.

(V) Consideration should be given to changing the tax treatment of paid OASI taxes against income taxes and raising this percentage later on. OASI benefits could be subject to full income taxation after retirees recover the cost of their nondeductible OASI contributions.

## Background

In 1988, the Social Security payroll tax rate jumped 36 basis points to 7.51 percent for each employee and employer. The maximum tax for employees moves up 8 percent or $248 from 1987 to $3,380. The maximum tax on the self-employed will be a hefty $5,859, up 9 percent or $472 from 1987.

In overall dollars, the 1988 social security payroll boost will amount to $16.6 billion, most all drained from the private sector. Little wonder that most all moderate- and many middle-income families pay more in social security taxes than they do in Federal income taxes. The same is true for millions of employers in labor intensive industries.

Despite the increasing burden of payroll taxes, the concern over the growth of entitlements generally, and serious threats to the long-term health of the system, it has proven extremely difficult to implement any restraint on benefits or structural changes in social security. For example, last fall the budget summit participants gingerly raised again the possibility of a slight cutback in the inflation indexing of social security benefits. Even a small adjustment here could have had a quite significant effect on budget outlays. But as soon as the word got out that the summit was even talking about such a move, the opposition quickly rose to the occasion. In fact, there wasn't even any need for a letter-writing campaign. Just the appearance on the evening news of Congressman Claude Pepper—a spokesman for millions of social security beneficiaries and a stout defender of the system—was enough to send everyone scuttling away from any changes.

This paper will look more closely at several aspects of social security financing:

(1) Short-term outlook and the relationship to the overall budget problem.

(2) The long-term imbalance and proposals to deal with it.

(3) Tax policy choices with respect to both (1) and (2).

## Going Into The 1990s

The old age, survivors and disability (OASDI) trust funds right now are beginning to build substantial surpluses, proba-

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bly averaging well over $50 billion per year for the next five years. Reasons for this are twofold:

(1) *Temporarily* there are more favorable demographic factors. There is a bulge in the employed work force paying taxes now as a result of the postwar baby boom, and there will be a relative dearth of retirees in the 1900-2000 period as a result of the baby bust during the Great Depression.

(2) The 1983 amendments raised payroll taxes substantially. It's important to note, however, that the *acceleration* of these taxes, both in terms of rate and base, is now over. We are back on the track of the pre-1983 amendments, albeit at a higher level. Under current law, only one more small rate increase is scheduled (in 1990), and there will be only "normal" expansion of the wage base in line with average wage levels.

## Table I

### Estimated OASDI and HI Income and Outgo By Alternative Assumptions Selected Calendar Years 1988-2060

($Billions)

| | Alternative II-B | | | Average of II-B and III* | | |
|---|---|---|---|---|---|---|
| Year | Income | Outgo | Surplus or Deficit(-) | Income | Outgo | Surplus or Deficit(-) |
| 1988 | $317.1 | $276.7 | $40.4 | $315.1 | $277.0 | $38.1 |
| 1989 | 335.8 | 294.8 | 41.0 | 331.1 | 296.5 | 34.6 |
| 1990 | 363.5 | 317.9 | 45.6 | 359.7 | 322.3 | 37.4 |
| 1991 | 387.2 | 340.9 | 46.3 | 384.3 | 349.4 | 35.0 |
| 1992 | 413.3 | 364.4 | 48.9 | 406.2 | 376.8 | 29.5 |
| 1993 | 440.8 | 388.8 | 52.0 | 435.2 | 404.7 | 30.6 |
| 1994 | 469.6 | 414.5 | 55.1 | 465.9 | 434.6 | 31.3 |
| 1995 | 499.5 | 441.5 | 58.0 | 497.9 | 466.1 | 31.8 |
| 2000 | 678.4 | 600.9 | 77.5 | 684.1 | 653.6 | 30.5 |
| 2005 | 915.4 | 817.6 | 97.8 | 931.8 | 915.4 | 16.4 |
| 2010 | 1,221.3 | 1,145.1 | 76.2 | 1,254.7 | 1,320.8 | -66.2 |
| 2015 | 1,609.4 | 1,662.4 | -53.0 | 1,666.7 | 1,975.4 | -308.7 |
| 2020 | 2,101.3 | 2,448.4 | -347.1 | 2,190.6 | 2,992.8 | -802.3 |
| 2025 | 2,736.3 | 3,540.6 | -804.3 | 2,866.5 | 4,448.6 | -1,582.1 |
| 2030 | 3,569.5 | 4,949.4 | -1,379.9 | 3,751.0 | 6,376.9 | -2,625.9 |
| 2035 | 4,663.0 | 6,675.7 | -2,012.7 | 4,910.4 | 8,777.4 | -3,867.0 |
| 2040 | 6,077.6 | 8,765.6 | -2,688.0 | 6,407.6 | 11,70[illegible].5 | -5,299.8 |
| 2045 | 7,904.4 | 11,448.3 | -3,543.9 | 8,332.4 | 15,479.9 | -7,147.5 |
| 2050 | 10,274.5 | 15,036.1 | -4,761.6 | 10,816.8 | 20,525.7 | -9,708.9 |
| 2055 | 13,369.6 | 19,805.5 | -6,435.9 | 14,046.9 | 27,237.9 | -13,191.1 |
| 2060 | 17,417.6 | 26,022.2 | -8,604.6 | 18,258.7 | 36,000.9 | -17,742.3 |

* Not an official projection of the Social Security Trustees.
Source: 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

In any event, the numbers have tempted some to claim there is no real problem with social security except, perhaps, that payroll taxes are too high. And, as social security is running such surpluses, it doesn't seem to have much to do with the Federal budget deficit. So why worry?

One reason is medicare. Despite efforts under budget reconciliation to reduce hospitalization costs, the hospital insurance (HI) fund is in far worse shape than OASDI. In fact, under the middle-range economic projections of the Social Security Trustees, the HI fund will be in deficit by 1998, and the assets exhausted six years later. Under the "pessimistic" projection, which may be the most realistic, the deficit date moves up to 1994 and funds would be totally depleted in 1999. The financing situation gets progressively worse in future years regardless of which economic assumptions are used.

For policy purposes it is often argued that medicare, both hospitalization (part A) and medical expense (part B), should be kept separate from the retirement and disability system. But the political pressure "to pay" for any future HI fund deficiencies with OASDI surpluses will be enormous. The funds have been comingled in the past and this is clearly the path of least resistance compared to future payroll tax rate or base increases.

At this point, we should take note of the new catastrophic care legislation. This *may or may not* affect the HI trust fund on a net basis. Although most of the additional costs under the legislation involve expanded hospital benefits, these costs supposedly would be financed entirely by increased premiums paid by medicare recipients and periodically transferred to the HI fund. Most of the premium increase would be related to income of eligible recipients and would rise in future years in accordance with medicare cost experience. Theoretically, therefore, the HI fund would not be further depleted even if costs exceed projections, which, given the history of medicare, would hardly be surprising. Whether Congress will acquiesce in continued sharp increases in these premiums—really progressive income taxes—on approximately 40 percent of the elderly is another matter. Catastrophic care provisions could easily accelerate and deepen the medicare financing problem.

## Shaky Projections

Given the problems of medicare, it makes sense to look at the *overall* social insurance financing picture combining OASDI and HI funds. This is done in Table I for two sets of alternative economic and demographic assumptions from 1988 on into the twenty-first century. Traditionally, most analysts focused on the middle range assumptions of the Social Security Trustees, specifically their II-B set of assumptions as shown in the table. More recently, however, the most pessimistic case—the Trustees' alternative III—is getting more attention and is said to be more realistic at least for the next decade. It's the only one assuming any recession in the 1990s. Alternative III may be too pessimistic particularly with respect to real wage increases, and for our purposes it makes sense to average the results of official projections II-B and III. This also is shown in the table.

If the averaging of II-B and III represents the most prudent look ahead, the combined OASDIHI funds would stay in surplus until after 2005; but the margin of income over expense would not be that large compared to the size of the program. Given all the variables in this exercise it could as easily be negative by the turn of the century. And almost regardless of economic assumptions used, the long-term picture after 2020 is one of overwhelming deficits.

### Budget Relationship

When the unified budget was adopted in the late 1960s, Federal trust funds, such as for social security and highway construction, became part of the official budget submitted to Congress every year. Analysts noted that the operation of these large funds had important implications for the credit markets and the economy. Therefore, they should be included in the overall budget plan. Although such funds were not subject to the regular appropriation process on an annual basis, Congress had the power to change the authorizing legislation and to influence the level of spending and/or taxation any time it chose to.

In the last two decades, entitlement programs, especially social security and medicare, have grown like topsy and have begun to overshadow the rest of the Federal budget. By FY 1987, social insurance payroll taxes were at $303 billion, or 35 percent of total budget receipts. Social security and medicare outlays (including part B of medicare financed by individual premiums) amounted to $284 billion, 28 percent total budget outlays, and 56 percent of total outlays excluding defense and interest costs. A legend began to build that a very large part of the Federal government was beyond control of the budget process. Budget reports began to separate government spending by the classification "relatively uncontrollable"—meaning social security benefits and interest in particular—and the remainder which supposedly Congress had better control over.

There is some truth in the notion of "relatively uncontrollable costs." Interest must be paid regardless of policy preference. And, as we have seen, it is very difficult to make changes in social security benefits on an annual review basis. The very description of social security as an *entitlement* program, whereby benefits are provided automatically to the qualifying population according to pre-set eligibility standards, indicates the strength of political commitment.

Partly because of the entitlement nature of social security benefits, many of the system's supporters have never accepted its inclusion in the unified budget. More recently they worried about the growing Federal deficit and the temptation to attack it through retrenchment of social security (so far much more of a temptation than a reality). Presumably, a social security system taken off the budget would be a less likely target for deficit reduction purposes.

To this concern was added another on general fiscal control. To the extent that the OASDI funds are in surplus now, they are helping to finance the deficit. In fact, without the OASDI surplus, the deficit would be $40 billion higher right now. According to Senator John Heinz (R-PA), removing social security from the budget should open the door for an effective across-the-board freeze on other spending.

These concerns appeared to carry the day in the 1983 social security amendments when Congress agreed to move the trust fund off-budget by FY 1993, later advanced to FY 1986.

Officially that is where the matter rests. Social Security is off-budget for purposes of drawing up the budget. However, in the critical Gramm-Rudman-Hollings procedure, it is promptly put back in for purposes of determining the size of receipts, outlays and the deficit reduction targets. Thus, those who would isolate social security from short-term budgetary pressures have not totally succeeded. Nor is it likely they will as long as social security remains a nonfunded operation.

### No Real Reserve

It is often said that the build-up of social security assets will be needed to finance the retirement of the babyboomers after 2020 without sending payroll taxes to sky-high levels. This is given as another reason for separating social security from regular budget concerns and keeping the assets intact. It would make a much better argument if there really was a social security reserve building up to take care of future retirees, similar to the operation of private sector and state/local government pension plans.

It doesn't work that way. The social security system holds paper promises from the Treasury to make good on those assets which are "invested" in government securities. The money from the current account surpluses actually is being used to support other government programs and allows the Federal government to borrow less from the private sector than it otherwise would have to do. When it comes time to draw down on social security assets to meet the benefit schedule in the next century, there will be no segregated "funds" available in the reserve. There will simply be the Treasury and its promise to pay, presumably backed by the taxpayers. Under the existing arrangement the only way for real resources to be set aside for future consumption (retirement and disability benefits) would be for the Federal government to run a surplus overall instead of a relatively small surplus in an agency account far outweighed by the deficit elsewhere. That is not about to happen for the foreseeable future.

Like it or not, we are faced with three general "givens" about social security financing.

- The system is not really creating reserve, but it cannot be described accurately as "pay as you go" either. The latter connotes a balance or near balance of income and outgo on a regular basis. It is instead a long-wave revolving fund that currently helps finance general government with a surplus of payroll taxes over expenses and which eventually will call on general government to redeem these excess contributions.
- Whether we designate social security on- or off-budget makes no real difference to the economy itself right now. In the near term, the overall effect on the econ-

omy must be assessed in terms of the total cash flow between public and private sectors. The nominal budget deficit may be higher or lower depending on how the trust funds are treated, but the government's borrowing needs from the public will not change. An extra dollar in social security taxes or reduced benefits will be a dollar not needed to be raised in the credit markets, and whether or not social security financing had any role in *causing* the current budget deficit does not change the basic relationship.

- By the same token, how we describe social insurance in terms of the budget may have a decided impact on political decisions as to the size and direction of the program as well as efforts to control the size of government in general.

## Fairness

For retirees first eligible in 1987 the average monthly OASI benefit was $745 for couples, and roughly two thirds of that for single individuals or surviving spouses. Clearly such benefits are not going to support a frivolous life style. However, past increases in benefits have been sufficient to help raise significant numbers of the elderly above the poverty level. If there are large cutbacks in benefits, critics charge that many of the elderly will be pushed back below the poverty level.

What if there were no actual cutbacks in current dollar benefits, just a slowing in benefit increases? This is what many proposals for retrenchment would do. A commonly offered one is the CPI-minus-two approach to limit the inflation indexing of both entitlement expenditure programs and the individual income tax structure to that increase in the consumer price index *above* a two percent floor. As long as the reported national inflation rate stays above two percent, which is a very likely scenario, the CPI-minus-two proposal would result in substantial budget savings—approximately $68 billion—during the period 1989-1993 for social security and railroad retirement programs alone. Applying the same adjustment to indexing of income taxes would yield somewhat less but still substantial budget savings in the form of revenue increases.

Proponents of the CPI-minus-two measure claim it would be a fair way to split the burden of deficit reduction without concentrating it unduly on any one sector and without making any *current* dollar reduction in benefits received. Moreover, if inflation heats up, program beneficiaries and taxpayers would still be protected from all but a small part of the reported inflation rate.

Every time such a proposal hits the press it immediately gets tagged as a "benefit cut" rather than a reduction in the rate of increase. Of course, there would be some cut in *real* benefits if the reported inflation rate accurately represented changes in the economic well-being of consumers. Over time the cumulative loss in real benefits, so defined, could be significant and it would have an impact on benefit recipients at all income levels.

No price indexing can capture fully the substitution effect of price changes on buying habits. In periods of high inflation, higher than 5 percent annually, the substitution effect of selecting less expensive—though not necessarily less useful—grades of products and services becomes marked. But it is not practical to change the weighting of the index frequently enough to reflect this on a regular basis. Therefore, a number of analysts believe the CPI has a persistent upward bias. In times of relatively modest inflation, this upward bias is undoubtedly less than 2 percent annually. During high inflation, it would run over 2 percent. Over the long run, it could average out to about 1 to 1 1/2 percent per year. Thus, the application of a 2 percent threshold on the indexing adjustment might well result in only slight erosion of real benefits after further adjustment for the substitution effect.

## Replacement Rates

A traditional method of measuring the adequacy of social security benefits is the extent to which they "replace" earnings just before retirement. As a result of benefit liberalization, particularly in the early 1970s, replacement rates rose sharply in the 1970s through 1981. Since then replacement rates have leveled off in the case of low earners and declined among workers with average earnings. The earlier double indexing of benefits had induced an abnormal bulge in replacement rates from the late 1970s through 1981. This factor was removed (decoupled) under the 1977 amendments with a delayed impact.

Still, replacement rates for both low earners and average earners are at historically high levels. For average-earning workers, they are running at 41 percent, 10 percentage points above the 1960s; among low earners, at 66 percent, about 25 percentage points above the 1960s. Furthermore, because they are based on the most recent earnings, social security replacement rates understate the relationship of benefits to earnings over a life cycle. If adjustments are made for this and other factors such as different tax treatment and the absence of child rearing expense, relative replacement rates would be much higher. Michael Boskin estimates such replacement rates for middle-income retirees at two-thirds previous earnings, and four fifths for modest income retirees.[1]

High replacement rates at the low end of earnings do reflect a deliberate setting of a "progressive" benefit structure. But overall it was never intended that social security should be the *major* source of retirement income. Private savings and pensions were to provide the bulk of support with social security fulfilling only the base need. Replacement rates over 50 percent for average earners certainly were not part of the original concept. There is evidence, in fact, that the growth in benefits and spread of the system to cover over 90 percent of the work force has displaced private savings for retirement and may be a contributing factor to the long-term decline in the personal savings rate.

Rates of return on social security—that is benefits received in relation to past payroll taxes paid—are still extremely generous. Current retirees at age 65, who were at the maximum creditable wage all along, recover the dollar amounts of their own contributions in less than 2 years. Low-wage earners recover their tax contributions in an even shorter time.

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[1] Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* (The Twentieth Century Fund,1986).

## Means Testing and Current Tax Policy

"Means testing" is a loaded expression. Those using it tend to shy away from saying exactly what they mean. It could be subjecting social security beneficiaries to a higher dose of income taxation. Or it could be a cutoff of benefits to those above some arbitrary income line. After "contributing" $3,000-$4,000 a year for some time in payroll taxes, how do you think middle America reacts to the latter?

Of course, a welfare element in social security through the higher replacement rates for low-income earners and a large transfer element to all retirees from the current work force have long been recognized. But system supporters have resisted stoutly attempts to isolate part of social security as income maintenance and apply income-based restrictions on benefits to middle- and upper-income retirees. The theory is that only if the system provides benefits across the board will it retain broad political support to redistribute income to the elderly poor or near poor. Strictly as a welfare program the potential cost of social security could be shrunk dramatically, but so, too, would its appeal to middle America.

This theory is backed by the tax/benefit structure of the current system. The payroll tax base supporting the system rises automatically with average wage levels and occasionally above that on an ad hoc basis such as under the 1983 amendments. In any case, *future benefit levels* are tied directly to covered wages. The sting of higher payroll taxes is softened in part at least by the promise of more benefits at retirement.

In the case of medicare the payroll tax/benefit connection has been more tenuous. In last year's budget reconciliation battle there was an attempt to break the connection for upper-income groups by eliminating the wage cap on the HI payroll tax base and using the proceeds, estimated at over $6 billion in the first full year, for deficit reduction completely unrelated to medicare benefits. The attempt failed, but it could come up again. In the meantime, catastrophic care legislation will weaken the link between payroll taxes and medical benefits by forcing the elderly to finance more of their benefits with income-related premium increases.

At this juncture, it's still hard to see any serious move to disassociate benefits of the basic old age and disability program from payroll tax contributions. *Direct* means testing of benefits seems unlikely.

Income taxation of benefits could be considered an *indirect* means testing. Currently, retirees with income of over $32,000 (joint return) and $25,000 (single) are subject to income taxation on half their social security benefits. Receipts from this source are transferred to the OASDI trust funds. Now, that amounts to only about $4 billion, less than 2 percent of the total income flow. Under current law, however, this proportion will rise quite sharply in the years ahead because the income tax thresholds are not indexed. More and more retirees will find themselves subject to income taxation on benefits even if only modest inflation continues.

Proposals have been made to extend the income tax to more than half of benefits received with the existing or lower thresholds, on the grounds that past contributions of retirees have "paid" for only a very small part of benefits received. Former Speaker of the House, Tip O'Neill, suggested subjecting 85 percent of benefits to tax.

Clearly there are some important policy and equity considerations here. Until 1983, social security benefits were exempt from any income tax. There was never a deliberate legislative or broad policy determination to forego tax. It descended from court decisions and administrative rulings holding that social security benefits were akin to "gratuities" for which no service had been rendered.

Most analysts felt that these were pretty shaky grounds. No challenge developed until recently because of the prevailing view that the elderly, along with the disabled and unemployed, were a dependent group and deserving of tax forgiveness. That view is changing with respect to both unemployment compensation and OASDI benefits. But a move to tax as much as 85 percent of benefits is a very large leap. Even if such a high level could be justified by actual rates of return currently, these rates will be declining in the future and 85 percent coverage would lead increasingly to double taxation.

A case can be made that social security benefits should be treated similarly to contributory pensions. Under current law, such pension recipients are subject to income taxation of their benefits but also are allowed to exclude the cost of their own after-tax contributions according to a formula based on life expectancy. If the retiree dies before his or her cost is recovered, the basis is passed on to heirs or beneficiaries. This latter element would be very difficult to graft onto a public income transfer program. Alternatively, retirees could be allowed to recover their own social security contributions first, deferring imposition of income tax accordingly. This would be akin to the former three-year rule on contributory pensions. The Treasury would lose some revenue from the deferral of income tax, but this would be far more than offset by the additional revenue from imposing tax on more than 50 percent of benefits and from lowering or eliminating tax thresholds.

The dollar amounts involved can be gauged by reference to the tax expenditure tables prepared by Treasury and the Joint Committee on Taxation. The current revenue gain from full taxation of OASDI benefits is estimated at $16.8 billion. This represents, specifically, the difference between what is collected under current law from partial taxation of benefits above the threshold amounts and full taxation of all benefits above past employee payroll tax contributions. The dollar amount of this potential additional revenue would diminish in the future because the thresholds for taxing benefits under current law are fixed and will protect an ever diminishing proportion of income from tax. The difference between what will be realized under current law and under full taxation as defined above would diminish also. Nevertheless, the amounts would be quite substantial for many years, making a sizable contribution to the trust funds—and to deficit reduction too under our present accounting rules.

Modest- to middle-income beneficiaries would see some reduction in their net benefits if the income tax thresholds were removed entirely. However, assuming other allowances—the personal exemption and standard deduction which were liberalized considerably by the Tax Reform Act of 1986—keep pace with inflation, the additional tax burden would be quite modest at the low end. Alternatively, the thresholds for social security taxation could be continued, but at a lower level to assure net revenue gains.

## After 2000

The single most worrisome factor in the future of social security is also the most certain—the decline in the number of covered workers per OASDI beneficiary. Actually this ratio has been going down for years reflecting the maturing of the system. But as the babyboomers start retiring en masse after 2010, it will plunge from 3.3 in 1986 to 2.0 or below by the middle of the century. Because the major element in this relationship over the next 60-70 years is the number of workers and future workers already born, the real question is not whether, but how much, the ratio will decline. And this is the nub of the long-term problem with an income transfer program—simply not enough workers to support their elders in the style they have become accustomed to.

It should be emphasized that we would be facing this problem even if our birth rates were not skewed by events of the Great Depression and World War II. The aging of an intergenerational income transfer program almost inevitably would involve diminishing returns for future generations. This is why the social insurance system has often been characterized as a giant "Ponzi" game. The only way to avoid diminishing returns would be sustaining an extraordinarily high rate of productivity in the economy so that the growth of resources would offset both the natural maturing process of the system and the special demographic circumstances facing us in the next century. This is not a reasonable expectation.

An actual deficit in overall trust fund operations is not expected before the year 2000 unless the worst case of the Social Security Trustees develops. Under the middle range II-B assumptions, operating deficits would assume large proportions by 2020, well over $300 billion per year. Technically the funds still would not run out of money for many years after operating deficits began because of the accumulated assets in their accounts. But because these assets exist on paper only, the real crisis point would arrive along with the operating deficits. This is when real resources would have to be directed back from general government to pay the bills and when even more painful public policy choices would have to be made.

By mid-century the operating deficits under any scenario other than the most optimistic (and discredited) Alternative I of the Social Security Trustees become overwhelming—in the trillions of dollars. This is what provokes the spectre of payroll tax rates of 30-40 percent, or even higher, to support the existing schedule of benefits—a condition that no politician could tolerate. Obviously, should we proceed along such a track the system would break down before such confiscatory tax rates could be imposed.

## Current Political Problem

It's tempting to try to ignore possible events of 20-50 years ahead. But regardless of the 21st century trends, we are faced with a much more current political problem now—the growing realization among younger workers that they cannot and will not realize anything near the returns from social security enjoyed by their elders. Peter Ferrara, an attorney who has written extensively about social security issues, calculates that the real rate of return on employee and employer contributions for young workers now entering the labor force and who remain single ranges from -1.0 percent for those at the maximum creditable wage to 2.13 percent for the low-income worker at the minimum wage. One-earner couples would get somewhat higher rates of return ranging from 1.3 percent to 3.75 percent. But according to Ferrara, in no case would social security returns approach what pension or thrift plan participants reasonably could expect from private sector programs or other market investments.[2] Furthermore, most steps that could be taken to reduce future benefits or raise taxes either for deficit reduction purposes or to correct long-term imbalances in OASDI programs are likely to depress these returns further.

Another way to look at it is to compare the present value of benefits and expected benefits less taxes paid by age group and the subsidy element in total benefit payments. Calculations by Michael J. Boskin for various age groups as of 1984 posed the following:

**Table II**

**The Age Structure of Transfers under OASDI**

| Age (In 1984) | Present Value of Benefits and Expected Benefits less Taxes (average per family) | Transfers as Percentage of Total Benefits |
|---|---|---|
| 72+ | $69,000 | 89% |
| 62 - 71 | 45,000 | 64 |
| 52 - 61 | 36,000 | 45 |
| 42 - 51 | 31,000 | 32 |
| 32- -41 | 21,200 | 18 |
| under 32 | 16,000 | 17 |

Source: Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security*, ©1986 The Twentieth Century Fund, New York

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[2] Peter Ferrara, *Social Security Rates of Returns for Today's Young Workers* (National Chamber Foundation, 1986).

According to Boskin's calculations, the transfer element or subsidy in social security benefits is still very high for elderly retirees and quite substantial for those at or near retirement, but it shrinks dramatically for younger workers. For some, the present value of benefits less taxes paid may become negative.

Social security system supporters say such comparisons are misleading. They claim that the inflation indexing feature of social security, even if it were compromised to some extent by adjustments such as the CPI-minus-two, produces a more assured income maintenance than can be obtained usually in the private sector, and that the important protections of insurance and disability coverage under OASDI are not reflected. Nevertheless, most all observers would agree that the gravy days of social security are coming to an end. Future retirees will "pay" for a larger and larger share of their eventual benefits and the transfer element or windfall to today's retirees will continue to shrink and eventually disappear.

## Funding and Privatization

The idea of a funded, private sector alternative to social security has long held appeal for conservative critics. It had some success in development of IRAs and similar instruments which build retirement security while contributing to capital formation needs of the economy. *Replacing* social security with a private sector insurance plan, however, has never been able to overcome formidable doubts and obstacles.

- *Unfunded liabilities.* What to do with the trillions of unfunded liabilities of the present system? If a comprehensive funded program were started, participants might have to continue to support present retirees through payroll taxes while making contributions to their own retirement fund, doubling up the burden on the same generation.
- *The "cream skimming" argument.* How to reconcile the virtually universal coverage of social security with the risk averse practice of private insurance? And, could any sort of compulsory private sector plan covering the same broad population as social security offer the same type of returns that more limited market investments would?
- *Political poison.* So far every mention of "privatizing" social security has driven at least nine-tenths of the politicians the other way.

## Two-Tier Approach

Michael J. Boskin has proposed a comprehensive two-tier social security financing mechanism. The first tier would be a means-tested income benefit for the low-income elderly and/or disabled. This would be akin to the existing Supplemental Security Income program, but presumably would cover more of the elderly population. It would be openly acknowledged as a welfare program, competing with other government expenditures and should be financed with general revenues.

The second tier would continue to be financed by payroll taxes but would not involve transfers of income from the working population to retirees. Instead, all of this tier's benefits would be based solely on lifetime contributions, employer and employee, with the same actuarial rate of return to all beneficiaries. The transfer and annuity aspects of the present social security system would be separated cleanly.

Because the transfer element in the present system will be very substantial well into the next century, eliminating it just for those above average earnings should keep the system in surplus throughout, according to Boskin.[3] It probably also could "pay" for an expanded SSI program, although Boskin does not make that explicit.

Obviously, the two-tier proposal would mean lower benefits for middle- and upper-income retirees compared to those expected under the present system for some years. Although current retirees would not be affected, those retiring in the near future would get a sharp jolt in benefit reduction if the new program were implemented without a phase-in or other adjustment. Boskin does not appear to pay much attention to the implementation problem. He does indicate that the second tier beneficiaries should appreciate the more certain rates of return under a strict annuity program treating all future beneficiaries the same in actuarial terms. Thus, regardless of their retirement date or family status, they would get the same rate of return. Uniform treatment also would simplify retirement planning for both employers and employees. Those at the low end of the earnings spectrum would "lose" the most in the second tier benefits under this system, but would be protected by the means-tested tier one plan and presumably, therefore, would not be adversely affected on a net basis. The two-tier approach separating welfare from annuity elements also has been endorsed by the American Institute of Certified Public Accountants (AICPA). The accountants go on to recommend full income taxation of benefits paid but with a full deduction of OASI taxes paid by the employee against their income taxes. A phase-in period on full benefit taxation would be allowed to account for the nondeductible portion of previous payroll tax contributions.[4]

## Conclusions

Most people sense that social security is in some trouble—that promises made to the system's participants over the years will be very difficult to keep in the future. While substantial surpluses in the old age and disability funds are accumulating now, these will not last indefinitely.

There is great resistance to making any restrictive changes in social security benefits or in the financing structure. Partly this is due to the political muscle of the beneficiaries. The very size of the social security system in relation to the Federal budget and its rapid growth as an entitlement income transfer also make radical changes improbable. Nevertheless, corrective measures certainly are needed and some are possible. The fact that the worst troubles are far off does not diminish the need for taking action now.

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[3] Michael J. Boskin, op. cit.

[4] American Institute of Certified Public Accountants, *Suggested Improvements for Social Security Retirement System* (1987).

A significant near-term objective is to reduce the Federal budget deficit and raise the overall savings rate. This could be addressed by limiting the *increase* in social security benefits such as through the CPI-minus-two adjustment on inflation indexing. This particular proposal, if applied to both entitlement program outlays and the personal income tax structure, would mean substantial savings in expenditures and increases in revenue. It also would prolong the build-up of surpluses in the social security trust funds.

Some have argued that the social security system has not caused the budget deficit and that it would be unfair to cut benefits or not increase them as much as scheduled for lower income retirees. Because social security operates as a transfer program without any funded reserve, it really does not matter in economic terms whether or not it helped produce the present deficit. Any savings on benefits or increases in payroll or associated income taxes automatically would help alleviate the Federal government's overall financing problem and its call on the credit markets.

The fairness issue is more complicated. Social security benefits were liberalized considerably in the 1970s and the carryover of that has raised replacement rates—the ratio of benefits to previous earnings—for all beneficiaries. There is a very substantial transfer element—the payment of benefits above previous employer-employee contributions plus interest—going to all sectors but particularly at the lower income end. Across-the-board restraint, such as would be imposed by CPI-minus-two, could have an adverse effect on the real benefits of low- and middle-income retirees over a sustained period. If it were imposed only for a five year period, however, it would not appear to be that much of a burden for any income sector given the existing pattern of replacement rates and returns on past contributions.

There are proposals to raise or even eliminate the cap on the payroll tax wage base, or simply cut benefits to middle- and upper-income retirees. These are certain to arouse substantial opposition.

However, it may well be possible to reorient the benefit structure and *gradually* eliminate the transfer or subsidy element. This could be done through a two-tier system recommended by Professor Michael Boskin and by the AICPA. The annuity tier would continue to be financed by payroll tax contributions while the income support base logically would be financed by general revenues. The program would reduce benefits to middle- and upper-income retirees but would offer more certainty and equity among the participants, encouraging them to rely more on supplemental private retirement plans. Most important, it would put social security on a far sounder fiscal footing.

From a tax policy viewpoint, the AICPA proposal to subject OASI benefits to full income taxation with an accompanying deduction for OASI payroll taxes makes sense. It would rationalize the tax treatment of social security along the same lines as private pensions, IRAs and Keogh plans. It would lessen the present transfer of income between generations and make younger workers more willing to support the system. A problem, of course, would be the current revenue cost of the payroll tax deduction, but this could be largely offset by subjecting benefits to full income taxation with necessary adjustment to prevent double taxation. The deduction could be phased in, starting perhaps at 50 percent, the same as planned under current law for the self-employed. Then to complete the cycle, retirees would pay tax on all benefits received *after* recovering their own payroll tax contributions for which no deduction had been taken.

Some will object to a cost recovery rule that produces a lower effective rate of tax in the early retirement years and a higher rate later on. The alternative is to use a formula based on life expectancy to prorate the cost recovery as now is done for contributory pension plans.

A solution to the problems of financing social insurance with the best chance of success will involve changes in both the benefits structure and tax policy. The concept of a publicly financed retirement/disability system would be retained but middle- and upper-income retirees would be encouraged to rely more on private sector arrangements in keeping with the original intent of social security. Future rates of return will be lower for most participants. But this will happen anyway given the financial strains on the system. The larger question is whether or not necessary reforms can be implemented in a reasonable and equitable manner to take the pressure off social security. If not, the system could fall apart in class and generational warfare.

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***This article is drawn mainly from a Tax Foundation working paper of the same title dated March 15, 1988, but incorporates new data from the 1988 Annual Report of the OASDI Board of Trustees, dated May 5, 1988.***

(TYPICAL FAMILY, *from page 1*)

Federal taxes and inflation.

### Federal Taxes

Since 1980, Federal income tax on this family has risen 38.8 percent despite two major income tax reduction laws in 1981 and 1986. The bite that Social Security taxes take out of this family's income has increased rapidly, jumping 93.7 percent from $1,816 in 1980 to $3,518 by 1988. Social Security will claim 7.5 percent of this family's 1988 earnings, up from 6.1 percent in 1980. Direct Federal taxes will take 19.5 percent of this family's 1988 income, down slightly from the 1981 peak that claimed 20.3 percent.

### Inflation

The most significant reason for the increase in this family's purchasing power since 1980 is the leveling off of inflation. Inflation had increases an averaged 8.9 percent from 1973-1980 and stood at 13.5 percent in 1980. It has averaged a 4.6 percent annual rate since 1981, while the two-earner family's income has grown by an average of 5.9 percent for the same period.

The sizeable 58 percent nominal income gain the two-earner family has made since 1980 has been reduced to only a 10.9 percent gain after direct Federal taxes and inflation are taken into account. Other indirect Federal taxes and state and local tax increases not shown here have further offset the family's increased earnings. However, measured in constant 1988 dollars, the two-earner family managed to obtain an average 1.3 percent yearly increase in real income, after direct Federal taxes, between 1980 and 1988.

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## THE FRONT BURNER

**By Robert C. Brown**
**President, Tax Foundation**

### "A State-Managed Industrial Sector"

The 100th Congress has come within a whisker of Europeanizing American industry, saved from its foolishness only by a greatly deserved Presidential veto. The step toward European-style socialism was, of course, the plant closings notification issue grafted onto the trade-bill to make the provision, Congress hoped, veto proof.

As is typical, fairness was the rubric under which the anti-business forces on the Hill mustered the troops. After all, isn't it only reasonable to demand that employers announce closing sufficiently long in advance to enable those affected by the shut-down to make other plans? How easy it is to cloak market-stifling social and economic policy in motherhood-and-apple pie rhetoric.

What the notifications proviso really does, of course, is to attack the market system at its very heart—that the free and open competition for economic resources be dictated by supply and demand. On the front end, it means that companies cannot close superfluous or inefficient plants in response to market conditions. This short-term attempt to prolong the current jobs of employees will have long-term harmful effects on them, their communities and future generations of workers.

Companies will find they cannot quickly shut down operations deemed unnecessary in a given part of the business cycle. Compliance will require a level of accuracy in forecasting that would test the clairvoyant skills of a gypsy fortune teller. Early advance notice will quickly drain companies of talented, motivated and younger workers — traditonally those in greater demand on labor markets — leaving firms at the mercy of workers with less potential for reemployment. Local governments would be given a role in "monitoring" compliance tantamount to putting the fox in charge of the hen coop.

Businessman will cope. They will soon learn that the answer is to be extremely cautious about reopening plants or building new ones during economic rebounds.

What this will do, as has been noted above, is Europeanize American industry. Because any new jobs created will have to be sustained even when market forces dictate otherwise, firms will hold back on creating new jobs. We will have the flat, static employment patterns of Europe, with great numbers of permanently unemployed or underemployed individuals. We will have erosion of the innovation and risk-taking that characterize a vital business sector, as social policy dictates that businessmen continue to keep open factories that are no longer justified by sales forecasts.

Besides squelching the entrepreneurial spirit, advance closing notice will fail to serve the long-term interests of the labor market by drastically slowing the creation of jobs. It will hinder economic growth by increasing the "notch" to be reached before a venture becomes worth pursuing. And it will reduce corporate tax revenues which closely track the levels of job creation and industrial capacity levels.

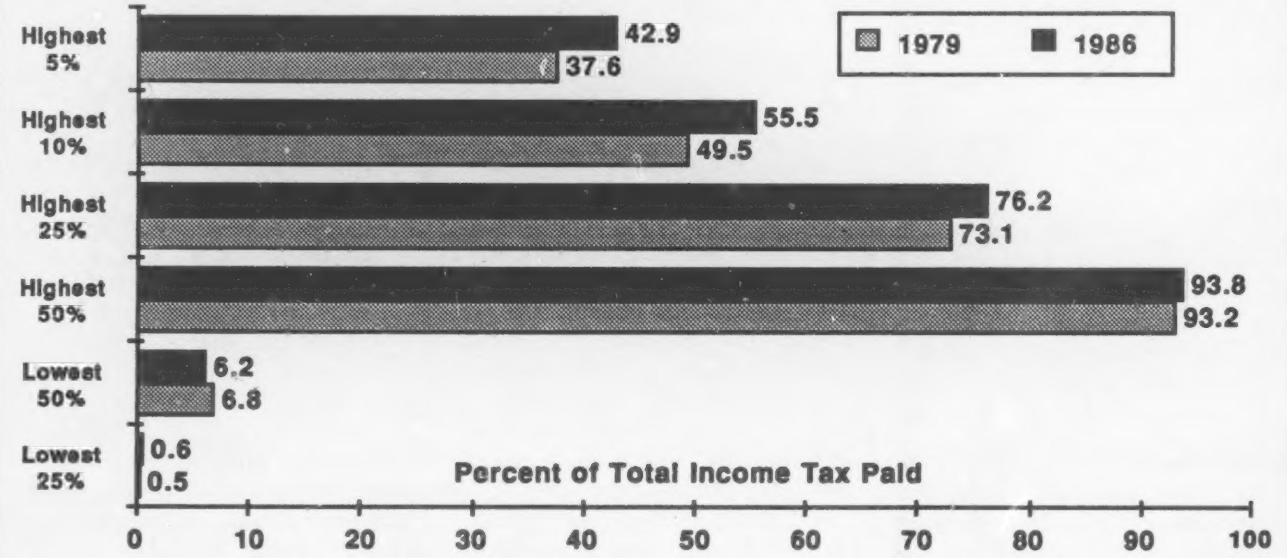
**Addendum:** *"The Competitive Burden: Tax Treatment of U.S. Multinationals"* has turned into a Foundation best seller. An interesting sidelight: Representatives of foreign governments in Washington have ordered numerous copies.

(TAX BURDEN, *from page 1*)

top ten percent paid $20,248, 77 percent more than they paid in 1979. While the top 10 percent, or 10.3 million earners, paid well over half the total income tax in 1986, their adjusted gross income ranged down to $48,980, which is not exactly "fat cat" status. It still takes millions of basically middle and upper-middle income taxpayers to pay the bulk of the total income tax bill.

The average tax rate in 1986 ranged from 3.4 percent for the lowest 25 percent to a high of 26.3 percent for the top five percent, indicating the broad progression of the system. Tax data exemplifies that the across-the-board tax rate reductions established by ERTA in 1981 fostered a sharp increase in the tax share paid by upper income individuals. Further changes under the Tax Reform Act of 1986 should make the overall system a little more progressive, particularly by removing approximately six million low-income earners from the rolls.

**Figure I**



## Table I

### Federal Income Taxes Paid by High and Low-Income Taxpayers, 1979 and 1986[a]

| Adjusted Gross Income Class | Income Level | | Percent of Tax Paid | | Average Tax | |
|---|---|---|---|---|---|---|
| | 1979 | 1986 | 1979 | 1986 | 1979 | 1986 |
| Highest 5% | $ 39,900 or more | $ 67,000 or more | 37.6% | 42.9% | $ 17,407 | $ 31,309 |
| Highest 10% | 32,710 or more | 48,980 or more | 49.5 | 55.5 | 11,456 | 20,248 |
| Highest 25% | 21,760 or more | 32,420 or more | 73.1 | 76.2 | 6,769 | 11,132 |
| Highest 50% | 11,870 or more | 17,148 or more | 93.2 | 93.8 | 4,315 | 6,845 |
| Lowest 50% | 11,869 or less | 17,147 or less | 6.8 | 6.2 | 313 | 455 |
| Lowest 25% | 5,565 or less | 7,806 or less | 0.5 | 0.6 | 46 | 90 |
| Lowest 10% | 2,212 or less | 3,123 or less | [b] | [b] | 9 | 27 |

### 1986 Income and Tax Data

| Adjusted Gross Income Class | Total Individual Returns (thousands) | Total Adjusted Gross Income ($billions) | Percentage of Adjusted Gross Income | Average Tax Rate |
|---|---|---|---|---|
| Highest 5% | 5,165 | $ 613.7 | 24.3% | 26.3% |
| Highest 10% | 10,330 | 909.2 | 36.0 | 23.0 |
| Highest 25% | 25,825 | 1,512.7 | 60.0 | 19.0 |
| Highest 50% | 51,650 | 2,139.6 | 84.8 | 16.5 |
| Lowest 50% | 51,650 | 383.0 | 15.2 | 6.1 |
| Lowest 25% | 25,825 | 68.0 | 2.7 | 3.4 |
| Lowest 10% | 10,330 | -16.2 | — | — |

[a] Data for 1986 are preliminary.
[b] Less than .07 percent.

Source: Tax Foundation computations based on Statistics of Income, Internal Revenue Service, U.S. Department of the Treasury.

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Some highlights of the 1988-1989 edition:

✱ Total government spending per person was up 143 percent from $2,886 in 1976 to an estimated $7,012 in 1986. The Federal government spent $4,490 per person, state government $1,424, and local government $1,097.

✱ Total government tax revenues per person were up 131 percent from $2,063 in 1976 to an estimated $4,774 in 1986. The Federal government collected $3,131 in tax revenue per person, state government $1,039, and local government $604.

✱ The 1986 Tax Index for all taxes was at 561.6 (1967=100). The biggest tax increases as measured by the tax index has occurred in social insurance contributions at 828.4 (1967=100).

✱ Estimated Federal, state, and local debt increased 15.4 percent in 1986, reaching $2,765,070 million, a 217 percent increase from 1976.

✱ Of the 23 nations belonging to the Organisation for Economic Cooperation and Development (OECD), the U.S. ranked 20th in tax revenues as a percentage of GDP in 1985 with 29.2 percent. At the high end were Sweden (50.5 percent), and Denmark (49.2 percent). At the low end were Japan (28 percent) and Turkey at 16.1 percent of GDP.

✱ In 1987 there were 98.5 million households, up 1.1 percent from 1986, with each household averaging 2.66 persons.

✱ In 1986 17.8 percent of the U.S. population was 25-34 years of age, numbering 42.8 million. By the year 2030, 21.2 percent of the population will be 65 and older, numbering 64.6 million.

✱ Connecticut had the highest per capita personal income in 1986 at $19,600 — the lowest was Mississippi at $9,716.

✱ The personal savings rate fell from 7.6 percent in 1976 to only 4.3 percent in 1986.

✱ Estimated Federal tax collections increased ten percent from 1986 to 1987 and are projected to rise 9.2 percent in fiscal year 1988.

✱ The average salary of a full-time Federal civilian employee was $27,375 in 1987.

✱ Of the 49 largest cities in 1985, Washington, D.C., had the highest per capita general expenditures at $4,551 — the lowest was El Paso at $391.

*Facts and Figures* belongs on the reference shelf of every person interested in public finance.

(GRANTS-IN-AID, *from page 2*)

tax costs for grants, 18 states were net "losers" in 1987; i.e., their aggregate Federal tax burden to support grant programs exceeded the amount of grants received by their respective state and local governments. As a whole, the 124 million residents of these "paying" states paid $56 billion in Federal taxes to support such programs while their state and local governments received $45.8 billion in grants — an average Federal tax burden of $1.22 for each dollar of grants received. In the "winners" column were the other 32 states and the District of Columbia, who paid an average of 82 cents in Federal taxes per dollar of aid. These 32 states and D.C. received $57.1 billion in Federal grants while paying only $46.9 billion to the Federal government in order to support these grant programs.

For the second year in a row, residents of Florida paid the highest tax premium per dollar of Federal aid. Floridians paid $1.60 in taxes per dollar of aid, up from $1.50 in FY86. Other states with high tax premiums were Texas ($1.41), New Jersey ($1.37), Connecticut ($1.36), New Hampshire ($1.30), and Colorado ($1.27).

Among the "receiving states," residents of the nation's capital got the best bargain, paying 36 cents per dollar of Federal aid. Other jurisdictions at the low-cost end include Alaska (49 cents), South Dakota (50 cents), Mississippi (53 cents), and Montana and West Virginia at 54 cents.

Tax Foundation's methodology for deriving the Federal tax burdens borne by residents of each state is designed to show where the tax dollars actually originate rather than where they were collected. Grants-in-aid are based on data reported by the Bureau of the Census, with adjustments made for shared revenues and data for outlying territories.

Many Federal grant programs require that the state and local recipients match Federal funds with their own. Tax Foundation economists estimate that state and local governments were required to provide 41 cents for every dollar they received in Federal grants, up from the 37 cents needed in 1980. State and local governments raised an estimated $42.2 billion to match the $102.9 billion received in 1987. Total Federal, state and local costs of the grants programs were $145.1 billion for FY87.

Tax Foundation analysts point out that these comparisons of Federal tax burdens for aid assistance do not reflect the entire cost to state and local governments of obtaining grants. In addition to the estimated $42.2 billion these jurisdictions had to raise to match Federal payments, there are additional costs associated with administering the federal grants programs.

The table on page two provides state-by-state data on Federal grants as compared to Federal tax costs in Fiscal Year 1987. Further details are provided in the "Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1987," available from the Tax Foundation for $4.00 plus $1.00 postage and handling.

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TAX FOUNDATION'S VOL. 32, NO. 5 JULY/AUGUST 1988

# TAX·FEATURES

## Shadow Budget Committee Urges Deficit Reduction upon National Economic Commission

"The National Economic Commission will be judged by its success or failure in mapping a substantial and permanent reduction in the budget deficit," Tax Foundation's Shadow Committee on the Federal Budget asserted in a recent submission to the NEC, adding, "Nothing else it does will amount to much if the Commission fails to achieve this."

Pointing out that the NEC must "come to grips with the staggering general fund deficit that looms ahead," the Shadow Budget Committee indicated a number of specific objectives the NEC should follow to get "the battered Federal budget process" back on track:

- To raise the national savings rate, the Federal government should aim for a surplus in the unified budget.
- The ratio of Federal debt to GNP should be stabilized at once and lowered in the long run.
- The Commission should recommend concrete actions to reduce the annual deficit by at least $100 billion by 1993.
- The balances in the Social Security funds should be preserved to pay future benefits. They should not finance increases in public consumption or be budgeted in ways that mask the underlying deficit.
- The Budget must be free from gimmicks that misrepresent the true size of the deficit.
- The budget process should be strengthened to encourage cooperation between the President and Congress and more orderly action in the House and Senate.

The Shadow Budget Committee's submission to the NEC includes a table that highlights how the "startling contrast between a fairly stable budget deficit and a rising debt will be even more pronounced in the next decade."

In a model package of spending cuts and reve-

(Continued on page 5)

**The Tax Foundation**
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**Details on page 8**

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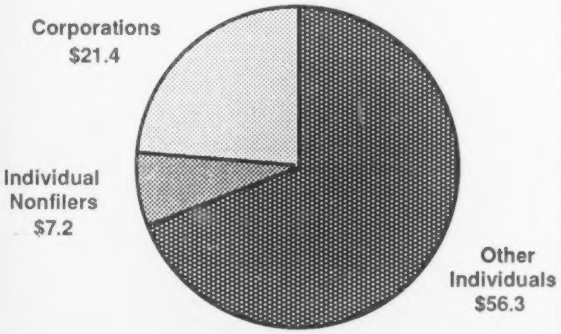
### *Persistent Tax Gap Due Mostly to Individual Underreporting*

Tax evasion continues to be a serious problem despite the increase in tax reforms introduced over the past decade in an attempt to make the system more equitable and efficient. The Internal Revenue Service recently estimated a tax gap of $84.9 billion for tax year 1987 and expects the gap to widen to $114 billion by 1992, exemplifying the continued seriousness of the problem. Tax evasion is as old as taxing itself. However, in terms of real dollar amounts, a 1987 report of the American Bar Association's Commission on Taxpayer Compliance noted that noncompliance has been increasing over time at approximately a 4.1 percent inflation adjusted annual rate.

The income tax system in the United States has one of the highest voluntary compliance levels in the world; approximately 83 percent of taxes owed on legal income is voluntarily reported and paid. However, millions of honest, conscientious taxpayers are carrying the burden of those who choose to evade their tax obligations. A tax gap approaching $90 billion is unacceptable because it redistributes income from honest taxpayers to dishonest taxpayers and aggravates the deficit problem.

(Continued on page 2)

**Total 1987 Tax Gap: $ 84.9 Billion**



(TAX GAP, *from page 1*)

The tax gap represents tax evasion, defined as the reduction of tax liability by illegal or fraudulent means. Tax evasion should not be confused with tax avoidance, which is the reduction of tax liability by taking advantage of provisions offered by law. The income tax gap presented here is only part of the picture. It *does not* include lost revenues from employment and excise taxes or gaps in remittance income. Also excluded are untaxed illegal activities in the so-called "underground economy," estimated to involve an additional $10 billion in lost revenues per year.

Most of the income tax gap for 1987 is attributable to individuals, amounting to $63.5 billion or 74.8 percent of the total gap while the corporate tax gap, estimated at $21.4 billion, represents 25.2 percent. Of the three possible sources of the tax gap—underreported income, overstated deductions and credits, and math errors—underreported income by individual filers contributes by far the largest amount.

In tax year 1987, individuals failing to properly report their income will cause an estimated $56.3 billion loss in revenues. Another $7.2 billion will be lost due to individuals who do not file returns at all. With regard to tax cheating, it is often asserted, "Everyone else is doing it so I'm entitled to do it." Furthermore, many Americans who personally disapprove of tax cheating are willing to condone it in others.

Perhaps tax evasion would be less acceptable when the actual cost to the average taxpayer is highlighted. For 1987, Tax Foundation economists estimate that a $63.5 billion individual tax gap would translate into $607.42 per individual return. For individual returns with taxable income, the allocation would be even greater, reaching $641.81 per return.

## Distribution of the Gross Income Tax Gap by Source

### Tax Year 1987

| Source of Gap | Tax Gap ($millions) | | Percent Distribution of the Tax Gap | |
|---|---|---|---|---|
| **Total Income Tax** | | $ 84,874 | | 100.0% |
| **Individual Income Tax** | | $ 63,475 | | 74.8% |
| Filers of tax returns | | $ 56,301 | | 66.3% |
| Underreported income | $ 48,292 | | 56.9% | |
| Wages and salaries | 1,417 | | 1.7 | |
| Interest and dividends | 3,227 | | 3.8 | |
| Capital gains | 6,650 | | 7.8 | |
| Informal suppliers[a] | 7,739 | | 9.1 | |
| Other nonfarm proprietor income | 16,646 | | 19.6 | |
| Farm income | 1,904 | | 2.2 | |
| Partnership and small business income | 3,216 | | 3.8 | |
| Pensions and annuities | 123 | | 0.1 | |
| Rents and royalties | 3,141 | | 3.7 | |
| Estate and trust income | 64 | | 0.1 | |
| State income tax refunds | 86 | | 0.1 | |
| Alimony income | 173 | | 0.2 | |
| Taxable unemployment and social security benefits | 338 | | 0.4 | |
| Other income | 3,566 | | 4.2 | |
| Overstated subtractions | 6,062 | | 7.1 | |
| Adjustments | 545 | | 0.6 | |
| Deductions | 3,478 | | 4.1 | |
| Exemptions | 2,039 | | 2.4 | |
| Credits | 899 | | 1.1 | |
| Math errors | 1,049 | | 1.2 | |
| Nonfilers of tax returns | | $ 7,174 | | 8.4% |
| **Corporate Income Tax** | | $ 21,399 | | 25.2% |
| Small corporations[b] | | $ 5,225 | | 6.2% |
| Underreported income | $ 2,519 | | 3.0% | |
| Overstated deductions | 2,706 | | 3.2 | |
| Large corporations[b] | | 15,845 | | 18.7 |
| Other[c] | | 329 | | 0.4 |

[a] Proprietors who operate with informal business styles, e.g. unreported income from roadside or sidewalk vendors, moonlighting craftsmen, unlicensed providers of child or elderly care services, and similar informal operators.

[b] Small corporations = assets under $10 million. Large corporations = assets of $10 million or more.

[c] Consists of $164 million gap for fiduciaries and $165 million gap for unrelated business income of tax exempt organizations.

Note: Details do not add due to rounding.

Source: U.S. Department of the Treasury, Internal Revenue Service.

## 1987 Individual Tax Gap Per Return

| – | Millions | Tax Gap Per Return |
|---|---|---|
| Number of Individual Returns | 104.5 | $ 607.42 |
| Number of Individual Returns With Taxable Income | 98.9 | $ 641.81 |

Source: Tax gap estimated by Department of Treasury, Internal Revenue Service. 1987 number of returns and tax gap per return estimated by Tax Foundation.

An individual tax gap amounting to well over $600 per individual return exemplifies the extent of the problem. The tax system itself is jeopardized when individuals are asked to support a system they believe is unfair and permits others to cheat with impunity. Tax evasion clearly threatens the voluntary compliance that is so central to the American tax system.

Experts agree that the tax gap cannot be closed completely. However, collecting taxes owed but not paid is certainly better than piling new taxes on those who do pay. Compliance with tax laws requires a certain amount of taxpayer belief in the system's integrity and ultimate sense of fairness. The Tax Reform Act of 1986 may help to improve the climate

*(Continued on page 5)*

*Budget Watch* By Allen Schick

# The Deficit That Won't Go Away

It wasn't very long ago that federal budgeting was a simple and straightforward matter. Most all revenue was collected in a single fund out of which government's expenses were paid. Nowadays, however, a growing portion of federal revenue is placed in a trust fund and earmarked for specific purposes. The federal tax structure is being transformed into a sort of "boutique" in which Americans pay the cost of services financed by earmarked revenue but not the full cost of the general services provided by the government. As a result, the government must borrow heavily to finance many of its most basic programs.

## Deterioration of the General Fund

The general fund finances all the expenses of the federal government except those paid out of trust funds. The $300 billion spent on national defense comes out of the general fund, as do more than $100 billion in aid to state and local governments, $150 billion in interest payments, and the operating expenses of almost all federal agencies. (The general fund also includes some money earmarked to special funds. The legal distinction between special funds and trust funds is not always clear.)

**Table 1**
**General Fund Receipts**
**Selected Fiscal Years**

| General Receipts: | 1950 | 1960 | 1970 | 1980 | 1989* |
|---|---|---|---|---|---|
| As a percent of total federal receipts | 90 % | 82% | 74 % | 68 % | 61 % |
| As a percent of general outlays | 92 | 101 | 92 | 81 | 71 |
| As a percent of GNP | 13 | 15 | 14 | 13 | 12 |

* 1989 is an estimate; all other years are actual.
Sources: Tax Foundation, Facts and Figures on Government Finance, except for 1989 which is computed from the U.S. Government Budget.

The general fund is bankrupt; it stays afloat by borrowing more than $200 billion each year. The steady deterioration in its financial condition is displayed in Table 1 which shows general revenue as a percentage of total federal receipts, general outlays, and the gross national product.

■ In 1950, 90 percent of all federal revenue was available for the general purposes of government. This percentage has dropped in each subsequent decade; at the present time, barely 60 percent of all federal receipts go to the general fund. With the scheduled growth in social insurance taxes, this percentage is certain to decline even more in the coming decades.

**Table 2**
**The Budget Deficit and Federal Debt**
**(dollars in billions)**

| | 1986 | 1988 (e) | 1990 (e) | 1993 (e) | Percent Change 1986 - 1993 |
|---|---|---|---|---|---|
| General Fund Deficit | $ 282 | $ 254 | $ 283 | $ 295 | 5% |
| Trust Funds Balances | 61 | 97 | 116 | 163 | 167% |
| Total Deficit | 221 | 157 | 167 | 134 | -39% |
| Federal Debt | 2,130 | 2,582 | 3,053 | 3,654 | 72% |

■ As late as the 1970s, general revenues sufficed to cover 90 percent or more of general outlays; now only about 70 percent of these outlays are financed by unrestricted revenue. This means that Americans are paying for less than three quarters of the cost of government. The shortfall is made up by borrowed funds.

■ Despite the overall rise in federal taxation, general revenues have actually declined as a percentage of the gross national product. In fact, they are now a smaller percentage of GNP than they were 40 years ago when the scope of federal programs was much more limited.

This adverse trend portends large, probably rising, general fund deficits as well as a growing debt burden. Table 2 indicates that most of the recent decline in the overall budget deficit (from a peak of $221 billion in the 1986 fiscal year to "only" about $157 billion in the current year) has been due to a buildup of balances in the trust funds. CBO projections for the next five years suggest that the entire improvement in the "baseline" deficit between now and 1993 will be due to the trust funds. The general fund deficit will actually grow. Because of this, there will be a continuing rise in the federal debt. The Office of Management and Budget has estimated that another trillion dollars will be added to the federal debt. With the burgeoning balances in the social security funds conveniently available to finance the general funds shortfall, the debt burden might swell to truly gargantuan size early in the next century.

## Earmarked Taxes—Yes; General Taxes—No

The deterioration in the general fund has occurred at a time when politicians are cross-pressured by citizens who want more benefits from the federal government but do not want to pay higher taxes. While there is nothing new about this inconsistent behavior, high deficits have forced Congress to change the way it responds to demands for expanded programs. In the past when deficits were low and the general fund was in sound condition, Congress could enact new programs without having to be immediately concerned about how to pay for them. But in an age of high deficits, Congress knows that it cannot add to federal spending without also providing

*(Continued on page 4)*

(BUDGET WATCH, *from page 3*)

the means to finance new programs. The expedient solution is to earmark the additional revenues for the programs being expanded. Recent earmarks include the following:

- The $8.5 billion superfund program enacted in 1986 is financed by a package of earmarked taxes on petroleum, raw chemicals, and U.S. corporations. In addition, more than one billion dollars is to be diverted from general revenues to superfund.
- A special tax has been levied on pharmaceutical companies in order to compensate persons injured by certain vaccines.
- The omnibus trade bill imposes a small fee on imports to finance retraining programs for workers displaced by imports.
- The expansion of Medicare's catastrophic illness coverage is to be financed by a sizeable increase in the premiums paid by elderly Americans into the Medicare trust fund.

> ***The federal tax structure is being transformed into a sort of "boutique" in which Americans pay the cost of services financed by earmarked revenue but not the full cost of the general services provided by the government.***

Earmarking might accelerate in the coming years as Congress faces demands for costly expansion in child care, health care, and other social programs. For example, recent proposals have called for financing home care of the elderly by removing the cap on medicare premiums.

Earmarks enable Congress to generate additional revenue without raising general taxes. But while earmarks link the taxes Americans pay with the benefits they get, this practice has a number of deleterious effects on the federal budget.

*Most earmarked taxes are not user charges.* A distinctive feature of recent earmarks is that they tax a particular segment of the population, but not just the one which directly benefits from the program. Thus, all taxpaying corporations, not only those responsible for pollution, pay earmarked taxes into superfund. All elderly Americans are charged for catastrophic coverage, whether they use this service or not.

*Earmarks erode the capacity of the United States to finance its ongoing operations.* Because they are coupled with spending increases, earmarked taxes do not ameliorate the general fund deficit. In practice, however, they may cause further deterioration in the general fund by (1) making it more difficult to produce revenues to pay general expenses and (2) imposing additional costs on the general fund. In this connection, it bears noting that superfund is financed in part out of general revenue, and that pressure to finance medicare out of general revenue is likely to increase if earmarked taxes prove insufficient to finance catastrophic care.

*Earmarks warp federal budget priorities.* Programs that can tap into earmarked sources can grow even when the budget is tight; less fortunate programs cannot grow, no matter how urgent the need is. This double standard pertains to existing programs as well. With a general fund deficit well in excess of $200 billion, the programs financed out of general revenue face cutback pressures. Virtually all the spending cuts in the 1980s have been in areas of the budget paid for by general revenue.

> ***. . . now only about 70 percent of [general] outlays are financed by unrestricted revenue. . . . Americans are paying for less than three quarters of the cost of government.***

*Earmarks undermine support of government.* Earmarking transforms Americans from citizens into shoppers. A citizen pays taxes in support of the broad purposes of government; a shopper pays for only the things he/she buys. As citizens we pay for the oldest and most basic functions of government such as the maintenance of law and order, the conduct of foreign relations, and the advancement of science. The huge general fund deficit is not just a bookkeeping entry; rather, it measures the extent to which the concept of government has been weakened.

> ***Congress knows that it cannot add to federal spending without also providing the means to finance new programs. The expedient solution is to earmark the additional revenues for the programs being expanded.***

Without a sound government that generates sufficient revenue to finance its operations, future shoppers might find their favorite boutiques closed because the physical and social infrastructure needed to keep them open is lacking.

**Correction**

The June *Budget Watch* should have said that of the JCT's $300 billion estimate of tax expenditures in FY'89, only 12 percent of these benefits, or $37 billion, are provided to corporations; approximately $260 billion go to individuals.

## Tax Features

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FEDERAL TAX POLICY MEMO

**Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy**

**JULY/AUGUST 1988**

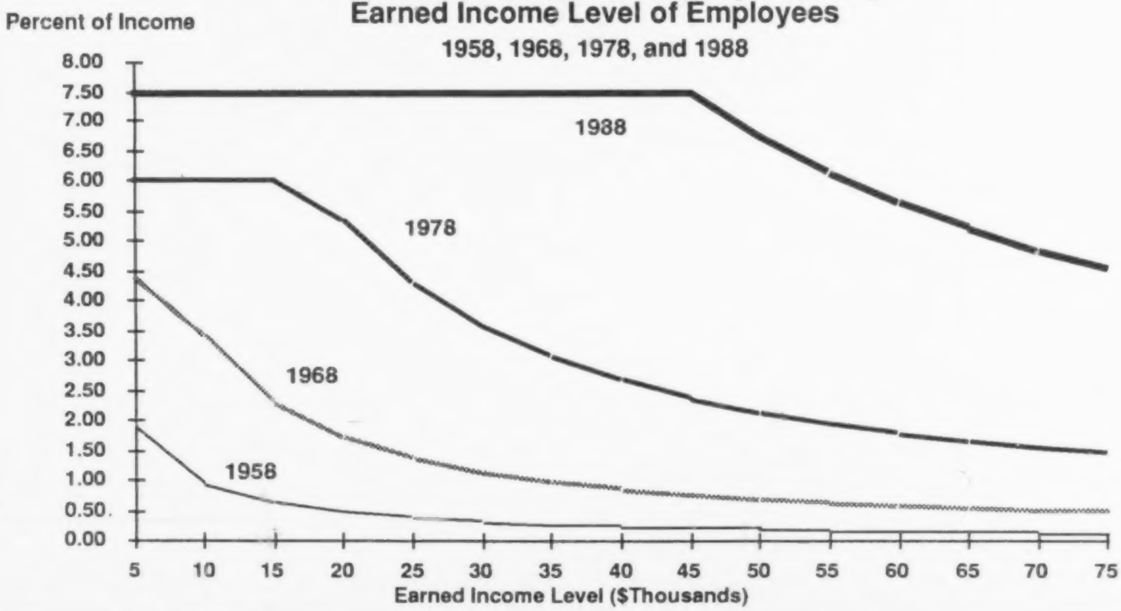
# Social Security Tax: How Regressive?

Public discussions of Social Security usually focus on the financing question of whether the program will be able to pay for all its promised benefits. However, a new and potentially more destabilizing issue is whether Social Security can be considered a good deal for present workers and those now entering the work force given the enormous tax burdens they must carry over their careers. The taxes in the early years of the system were quite low. The maximum annual tax, including both employer and employee shares, was $189 as late as 1958, and only $348 as late as 1965. Today, the maximum is $6,759 — far outpacing the growth of all other federal taxes. Another rate increase is already scheduled in 1990 and the base will go up automatically with average earnings. If the employer share is considered borne by employees, more than half of the workers in the United States pay more in Social Security taxes than they pay in personal income taxes.

While the Social Security tax burden has been rising for all workers, the increase has been noticeably more at the middle and upper-income earner levels (Figure 1). The 154 percent increase in the maximum taxable earnings from $17,700 in 1978 to $45,000 in 1988 has had a much greater impact on the contributions from middle and upper wage earners than the 1.46 point increase in the rate from 6.05 to 7.51 during the same period. A married couple both earning the maximum taxable earnings will now contribute $6,759 that must be matched by their employers for a total of $13,518 a year. Increases in the maximum taxable earnings have generally been introduced simply as a method of collecting additional revenues when the Social Security system is in financial difficulty without regard to horizontal equity.

The Social Security tax becomes regressive only for a narrow segment of upper income earners. When the entire system of taxes, bases, and benefits are examined, Social Security becomes more proportional and, in fact, progressive in the allocation of its benefits. Because of the weighted benefit formula under Social Security, retirees with a work history of low wages receive more generous benefits in relation to their earnings. The magnitude of the differences in benefit treatment for earners of different incomes is enormous. Table 1 illustrates the inverse scale of benefits to taxes paid. A retired low-earner worker first eligible in 1987 could receive maximum family benefits equal to 91.5 percent of his previous average monthly earnings, while the maximum earner could receive only 68.4 percent — 23 percent less than the low

**Figure 1**
**Effective Rate of Social Security Taxes by Earned Income Level of Employees**
**1958, 1968, 1978, and 1988**



*Material in* Federal Tax Policy Memo *may be reproduced freely. Credit to Tax Foundation would be appreciated.*

## Table 1
## Illustrative Monthly Benefit Amounts By Average Indexed Monthly Earnings For Selected Wage Levels

| Insured Worker | First Eligibility in 1987<br>Low earner | <br>Average earner | <br>Maximum earner | Percent of average indexed monthly earnings<br>Low earner | <br>Average earner | <br>Maximum earner |
|---|---|---|---|---|---|---|
| Average indexed monthly earnings | $ 740.00 | $ 1,403.00 | $ 2,205.00 | - | - | - |
| Primary insurance amount | 434.00 | 655.10 | 862.40 | 58.6% | 46.7% | 39.1% |
| Maximum family benefits | 677.30 | 1,195.40 | 1,508.60 | 91.5 | 85.2 | 68.4 |

Source: United States Social Security Administration and Tax Foundation Computations.

earner. Furthermore, the actual replacement rates for retired workers have increased substantially for low-earners from 40 percent in 1965 to 71.2 percent in 1988 (Table 2). Conversely, the actual replacement rate for the maximum taxable wage earner has declined substantially from 32.9 percent in 1965 to 23.0 percent in 1988.

Another major factor affecting Social Security benefits for different income levels is the taxation of benefits that began in 1984. Taxation of Social Security benefits affects retirees with relatively high incomes. One half of Social Security benefits is treated as taxable income for retirees with annual income over $32,000 (joint return), $25,000 (single). In tax year 1986 the taxable portion of Social Security benefits for these high income earners accounted for an additional $10.7 billion in taxable adjusted gross income. Furthermore, beneficiaries aged 65-70 whose annual benefits exceed $8,400 per year lose $1 in benefits for each $2 earned above that amount. On the other hand, an important factor that shifts the tax burden from low income workers is the Earned Income Credit. Low income workers with families are entitled to a tax credit of up to $851.20 a year on earned income of up to $15,431. The credit is intended to offset the impact of Social Security taxes on low-earning taxpayers and amounted to $380 million in 1985.

Examination of the entire Social Security system, including the tax and benefit structure, reveals a generally proportional system. However, with respect to rates of return, those who retired in the system's early years received high returns on the limited Social Security taxes they paid during their working years. While today's retirees are not enjoying as good a deal as the earlier retirees, they are still receiving above market returns. Replacement rates for the low earners have been increasing while the maximum taxable earners have witnessed a reduction in their earnings replacement rate.

Maximum taxable income couples who entered the workforce in 1985 are estimated by some to have a negative real rate of return from Social Security by the time they retire. Social Security withholdings traditionally have been considered "contributions" to a savings plan. However, with the expected negative real rate of return for those who now send in a total of $13,518 a year, it clearly becomes a "sunk" tax.

### Correction

*The final recommendation in the summary of the June FTPM should have read as follows:*

(V) Consideration should be given to changing the tax treatment of social security by allowing a deduction of 50 percent of employee-paid OASI taxes against income taxes and raising this percentage later on. OASI benefits could be subject to full income taxation after retirees recover the cost of their nondeductible OASI contributions.

*Also, in the table on page 2, interest income was inadvertently omitted. Including interest income would not change the basic long-term trends portrayed but probably would preclude operating deficits for the overall OASDIHI system until well into the 21st century.*

## Table 2
## Earnings Levels, Benefits, and Replacement Rates For Retired Workers in 1965, 1975, and 1988

Retired Workers At Age 65

| Year | Actual earnings in previous year<br>Low earner | <br>Average earner | <br>Maximum earner | Annual initial benefits (actual dollars)<br>Low earner | <br>Average earner | <br>Maximum earner | Annual initial benefits (1982 constant dollars)<br>Low earner | <br>Average earner | <br>Maximum earner | Replacement rates (in percent)<br>Low earner | <br>Average earner | <br>Maximum earner |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1965 | $ 2,600 | $ 4,576 | $ 4,800 | $ 1,040 | $ 1,439 | $ 1,580 | $ 3,182 | $ 4,402 | $ 4,834 | 40.0% | 31.4% | 32.9% |
| 1975 | 3,883 | 8,031 | 13,200 | 2,309 | 3,400 | 3,973 | 4,141 | 6,098 | 7,125 | 59.5 | 42.3 | 30.1 |
| 1988 | 6,968 | 17,857 | 43,800 | 4,961 | 7,536 | 10,074 | 4,124 | 6,264 | 8,374 | 71.2 | 42.2 | 23.0 |

Source: United States Social Security Administration and Tax Foundation Computations.

(SHADOW COMMITTEE, *from page 1*)

nue adjustments, the Shadow Committee recommended paring at least $100 billion from the unified budget deficit by 1993, and urges that a deficit-neutral rule be enforced to sustain "continuing restraint in discretionary domestic programs." (Under this rubric, any additional spending for new programs must be offset by compensatory cutbacks in other parts of the budget.)

| | $Billions |
|---|---|
| **Defense spending cutbacks** | **$ 25** |
| **Non-defense subsidy cutbacks** | **20** |
| **Restrain entitlement expenditures** | **10** |
| **Tax 85% of social security benefits** | **18** |
| **Impose a broad-based tax on energy consumption** | **19** |
| **Increase user fees** | **10** |
| | **$ 102** |

### Give Meaning to the Annual Budget Resolution

"The budget resolution has become a symbolic battleground in which small conflicts get magnified into big ones and deadlines are ignored because they have no meaning," the report concludes. "The Shadow Committee urges that the congressional budget process be overhauled by converting the annual resolution into an instrument for deciding revenues and expenditures. As a step in this direction, the budget resolution should be subject to presidential review, and it should be directly linked with revenue legislation and appropriation bills. Congress should make real, not symbolic, decisions when it votes on a budget resolution."

The Tax Foundation's Shadow Committee on the Federal Budget is a citizens' watchdog group acting under the auspices of the Tax Foundation, a Washington-based fiscal policy research organization. Members include The Honorable Harry F. Byrd, Jr., Leif H. Olsen, W. Bowman Cutter, Rudolph Penner, Paul H. O'Neill, and Allen Schick.

The complete report is available from the Tax Foundation for $4.00 plus $1.00 postage and handling.

## THE FRONT BURNER

**By Robert C. Brown**
**President, Tax Foundation**

### "The Great Silence"

To look at the Democratic and Republican Party Platforms, you would think we were living in the best of all possible worlds: no mention is made of taxes; no mention is made of deficits; no mention is made of spending cuts.

Although spending continues to run $150 billion higher than taxes, neither presidential candidate addresses the most pressing issues of the decade: tax and fiscal policy and deficit reduction. The "t" word and the "d" word go unspoken.

Quite simply, this is dishonest. We have been plagued for a generation now with a public that expects more from the national government than it is willing to pay for. This public has passed the bill forward to subsequent generations of Americans.

Yet neither candidate dares address this issue openly. By tacit agreement, the deficit reduction question has been finessed, passed to the National Economic Commission, which is not due to report until March 1989. Perhaps this will be a good thing, much like the resolution of the Social Security dilemma earlier in the decade by the Greenspan Commission. Perhaps only a bipartisan group with a mandate from both the Legislative and Executive Branches can muster the independence and courage to ask the hard questions and come up with at least some of the difficult answers.

Even so, one would hope to see a little more candor from those who aspire to the highest elective office in the land. To talk in vague generalities while ignoring the highest, most intractable deficits in our history is unconscionable. It models presidential politics after the race for top ratings in prime time network television. The rule is to air the least offensive programming possible, shows so bland and innocuous that the viewer will not be motivated to make the effort necessary to change channels.

Is that the kind of presidential campaign the United States wants and needs? Should the candidate who runs a campaign sufficiently vanilla-flavored that he antagonizes the fewest voters win the White House by a sort of reverse popularity contest?

One thinks of the great presidents of the past and speculates where the nation would be had they followed the course of least offensiveness. The beige party platforms and generic presidential campaigns now being run stand in pale contrast to the giants of the past who were willing to stand up and be counted *as they were running for office.*

It is saddening, and somewhat frightening, to think that we may be led into the nineties by whichever candidate best succeeds in ducking the tough quesions, by whoever avoids being pinned down on anything that might strike the voters as painful or difficult.

(TAX GAP, *from page 2*)

for compliance by eliminating some perceived sources of unfairness in the tax laws and perhaps more importantly, by lowering the tax rates. The latter, in effect, reduces the marginal dollar "benefit" of cheating. However, the frequent changes in the income tax code themselves foster increased uncertainty, frustration and noncompliance, at least in the short run. If the Internal Revenue Code would remain relatively stable, complexity and uncertainty about the law should become less important as a source of noncompliance.

## *Government and Your Tax Dollars*

# The Revenue Side . . . .

Nearly 28 cents of every dollar raised by Federal, state, and local governments in 1986 (latest reported) came from individual income taxes according to Tax Foundation economists. That totaled more than $423 billion of the $1.515 trillion that governments collected that year.

Social security payroll taxes were the second major revenue source, raising 17 cents for every revenue dollar, or $257 billion in 1986. Other major revenue raisers included:

- Current charges, 9.5 cents;
- Miscellaneous general revenue (e.g., interest earnings and government asset sales), 7.8 cents;
- Property taxes levied by state and local governments, 7.4 cents;
- Selective sales and excise taxes, and general sales taxes, 6.0 cents each;
- Corporate income taxes, 5.5 cents; and
- Miscellaneous taxes (death and gift, motor vehicle and operator's licenses, unemployment contributions and others), 4.4 cents.

Individual income taxes have held the top position for over 40 years. However, the dominance of this particular form of tax has waned. Their 27.9 cent share in 1986 is down from 30.3 cents in 1970 and 30.7 in 1980.

Tax Foundation economists attribute the relative decline of the personal income tax to two main factors: social security taxes and nontax revenues have grown more rapidly; and the Economic Recovery Tax Act of 1981 (ERTA) has slowed the rise of Federal income taxes. Similar effects can be expected due to the Tax Reform Act of 1986.

On the other hand, the slower growth in Federal income taxes since 1980 has been partially offset by the steady increase in state/local taxes. Since 1980, Federal individual income taxes have gone up by 43 percent while individual income taxes levied by subnational levels of government have jumped 73 percent.

### Emphasis on Nontax Revenues

Looking at the mix of taxes over the past quarter of a century, Tax Foundation analysts call attention to several major shifts:

- Revenues from nontax sources have risen from 17.3 cents per revenue dollar in 1960 to 25.8 cents in 1986. Nontax revenues primarily consist of current charges (e.g., revenues generated from rents, sales of commodities and services, and government commercial activities); miscellaneous general revenues (includes interest earnings, special assessments, and property sales); employee retirement; and utilities and liquor stores revenue. While nontax revenues have been increasing, tax revenues dropped from 82.7 cents per dollar in 1960 to 72.4 cents by 1986.
- Social security payroll taxes were the fastest growing of all tax sources during the period, rising from 7.0 cents per dollar of revenue in 1960 to 17 cents in 1986. Social security tax collections in 1986 were over 23 times as large as in 1960.
- State and local general sales taxes were the only other source showing a rising trend during the 26 years. Their share of the total increased from 3.5 cents per dollar in 1960 to 6.0 cents in 1986. Fiscal year 1986 revenue from general sales taxes reached $91 billion, 18 times 1960 levels.

Tax sources showing a declining role in the structure were property, selective sales and excises, corporate income taxes, and miscellaneous taxes.

Numbers on government revenues don't tell the whole story, Tax Foundation economists say. In fact, they understate the amount spent by government in 1986 by $182 billion. The Federal government financed $249 billion — almost one-fourth of its outlays by borrowing. State and local governments, on the other hand, took in $65 billion (9 percent) more than they spent, thus reducing the deficit for all governments combined to $182 billion, or 11 cents per dollar of spending. The fiscal 1986 deficit for all governments was almost seven times the amount shown in 1980, and 12 percent larger than the deficit recorded just one year earlier.

Additional details appear in the accompanying table.

### How Federal, State, and Local Governments Raise Each Dollar of Public Funds

**Selected Fiscal Years 1960-1986**

**(Cents Per Dollar of Total Revenue)**

| Source | 1960 | 1970 | 1980 | 1986 |
|---|---|---|---|---|
| Tax Revenues | 82.7 | 82.4 | 78.2 | 74.2 |
| Individual Income | 28.2 | 30.3 | 30.7 | 27.9 |
| Social Security (OASDHI) | 7.0 | 11.5 | 15.0 | 17.0 |
| Property | 10.7 | 10.2 | 7.3 | 7.4 |
| Selective sales and excises | 12.5 | 9.8 | 6.5 | 6.0 |
| Corporate income | 14.8 | 11.0 | 8.4 | 5.5 |
| General sales | 3.5 | 4.8 | 5.5 | 6.0 |
| Other taxes[a] | 6.0 | 4.8 | 4.8 | 4.4 |
| Nontax Revenues | 17.3 | 17.6 | 21.8 | 25.8 |
| Current charges | 8.1 | 7.9 | 8.6 | 9.5 |
| Miscellaneous general[b] | 3.3 | 4.0 | 6.7 | 7.8 |
| Employee retirement | 1.9 | 2.5 | 3.1 | 4.9 |
| Utilities and liquor stores | 3.2 | 2.6 | 2.7 | 3.1 |
| Other nontaxes | .8 | .6 | .7 | .5 |
| Exhibit ($Billions): | | | | |
| Total Revenues | $153.1 | $333.8 | $932.2 | $1,515.5 |
| Surplus(+) or deficit(-) | +$1.8 | +$.8 | -$26.5 | -$181.5 |

[a] Includes death and gift, motor vehicle and operators' licenses, unemployment contributions, and miscellaneous taxes.

[b] Includes interest earnings, special assessments, sale of property, and other general revenue.

Source: Tax Foundation computations based on data from U.S. Department of Commerce, Bureau of the Census.

# .... And The Spending Side

Social welfare programs consumed 31.8 cents of every government dollar spent in 1986 (latest reported). Nearly one third of all 1986 public expenditures, some $540 billion out of total spending by all levels of government of $1.697 trillion, went to support the social welfare network, Tax Foundation economists report. Other major spending categories are:

- National defense and international relations, 18.4 cents;
- Education expenditures, 13.2 cents;
- Interest costs, 10.7 cents; and
- Environment and housing, 5.8 cents.

### Social Welfare Spending Dominates

Federal social security (OASDHI) was the costliest spending program of all governments, claiming 15.8 cents of every dollar spent. Social welfare programs also include social services and income maintenance (public welfare, health and hospitals, and unemployment insurance), which accounted for 12 cents per dollar of government spending. Other social welfare programs included are government employee retirement, and veterans' programs not elsewhere classified, 4 cents.

As large as these percentages for social welfare spending are, they actually understate what could be considered the "true" social spending total, according to Tax Foundation researchers. Broadly defined, social welfare might include public education (see accompanying table), as well as subsidized housing and many veterans' services that are included in and not segregable from the totals of other spending categories.

### How Federal, State, and Local Governments Spend Each Dollar of Public Funds

**Selected Fiscal Years 1960-1986**

**(Cents Per Dollar Of Total Spending)**

| Source | 1960 | 1970 | 1980 | 1986 |
|---|---|---|---|---|
| Major social welfare programs, total | 20.1 | 25.5 | 33.2 | 31.8 |
| Social Security (OASDHI) | 7.1 | 10.8 | 15.6 | 15.8 |
| Social services and income maintenance[a] | 8.5 | 10.7 | 13.2 | 12.0 |
| Government employee retirement | 2.0 | 2.4 | 3.1 | 3.0 |
| Veterans (not elsewhere classified) | 2.5 | 1.6 | 1.3 | 1.0 |
| National defense and international relations | 32.3 | 25.3 | 15.6 | 18.4 |
| Education | 12.8 | 16.7 | 15.0 | 13.2 |
| Interest on general debt | 6.2 | 5.5 | 7.9 | 10.7 |
| Environment and housing | 5.4 | 4.4 | 5.0 | 5.8 |
| Utilities and liquor stores | 3.4 | 2.8 | 3.8 | 3.5 |
| Transportation | 7.6 | 6.2 | 4.5 | 3.7 |
| Public safety | 1.8 | 2.0 | 2.3 | 3.3 |
| Government administration | 1.8 | 1.9 | 2.2 | 2.4 |
| Postal service (Federal) | 2.5 | 2.3 | 1.9 | 1.8 |
| Sanitation | 1.1 | 1.0 | 1.4 | 1.1 |
| All other | 5.0 | 6.4 | 7.2 | 4.0 |
| Exhibit ($Billions): | | | | |
| Total spending | $151.3 | $330.0 | $958.7 | $1,697.0 |

[a] Includes public welfare, hospitals, health, social insurance administration, and other insurance trust expenditures.

Source: Tax Foundation computations based on data from U.S. Department of Commerce, Bureau of the Census.

### Two Decades of High Growth

During the 1960s and 1970s, spending on social welfare programs underwent a dramatic increase, rising from 20.1 cents per dollar of spending in 1960 to 33.2 cents in 1980. By contrast, national defense and international relations spending dropped from the 1960 level of 32.3 cents to only 15.6 cents in 1980.

Although data for the early 1980s show a modest 2.8 cents-per-dollar increase in the spending share for defense, the growth of this outlay category pales in comparison with what has happened to social spending over the last quarter century: Spending on social programs in 1986 came to 16 times what it had been in 1960, whereas all other programs combined, including defense, increased by just nine times over the same period.

### Education and Transportation Spending Down

Another notable recent trend has been a relative decline in spending for education and transportation. Education spending accounted for 15 cents per dollar in 1980. It now absorbs only 13.2 cents.

Transportation expenditures continue their sharp decline. They now stand at only 3.7 cents, less than half 1960 levels.

### Debt Payments Rise

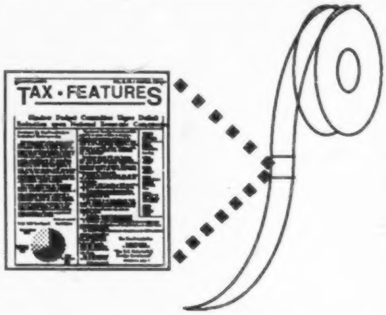
Fastest growing of all government costs have been debt-related outlays. Interest payments on government debt claimed 10.7 cents of each dollar spent in 1986, compared to a 7.9 cent bite in 1980 and 6.2 cents in 1960. The total cost of serving debt in 1986 was $181.2 billion.

The four largest spending categories — major social welfare programs, defense, education, and interest costs — accounted for nearly $1.3 trillion, or 74.1 cents of every dollar of Federal, state, and local expenditures in 1986.

The accompanying table provides further details.

## TF Publications Now Available On Microfiche

After several months of work with William S. Hein & Co., fifty years of Tax Foundation research, its entire collection of publications, can now be purchased on fiche.



Newsletters such as *Tax Features, Federal Tax Policy Memo, Library Bulletin and Washington News;* research publications like *Government Finance Brief* ; proceedings of meetings; *Special Report;* and many more can be bought separately or as part of the entire collection. *Facts and Figures on Government Finance* is available from 1941 up to, but not including, the current edition.

For more information, contact William S. Hein & Co., 1285 Main Street, Buffalo, NY 14209; or call 800–828–7571.

## Tax Foundation to Hold Seminar on U.S. Foreign Investment and U.S. Tax Policy on Multinationals

The critical role of U.S. dirct investment abroad is the subject of an upcoming Tax Foundation seminar entitled "The U.S. Stake in U.S. Foreign Investment." It will be held September 13, 1988 at the Vista International Hotel in Washington, D.C. After registration at 8:00 a.m. and continental breakfast at 8:15, the seminar's morning session will begin at 9:00.

- Martin S. Feldstein, President, National Bureau of Economic Research, will describe the impact of investment abroad on the U.S. economy.
- Walter Mossberg, International Economics Reporter, *The Wall Street Journal,* will discuss public and congressional attitudes.

To conclude the morning session, business views on U.S. competitiveness abroad will be presented by:

- Robert L. MacNeill, Executive Vice Chairman, Emergency Committee on American Trade;
- James Riordan, Vice Chairman and Chief Financial Officer, Mobil Corporation; and
- Kenneth Kermes, Executive Vice President, Corporate Finance, SmithKline Beckman Corporation.

Following a noon reception and a luncheon session—Senator Alan Cranston is invited to speak—an afternoon session will begin at 2:00 p.m. Tax policy as applied to foreign investment will be the subject, and the speakers will be:

- The Honorable O. Donaldson Chapoton, Assistant Secretary of the Treasury for Tax Policy;
- Gary Hufbauer, Wallenberg Professor of International Finance, Georgetown University;
- Ray Haas, International Tax Partner, Arthur Young & Company; and
- Robert Z. Lawrence, Senior Fellow, Department of Economics, The Brookings Institution.

These speakers will examine the impact of U.S. investment abroad on the U.S. economy, the current confusion in national policy regarding investment abroad, and the type of tax policy that can further U.S. competitiveness in overseas markets.

While the role of U.S. multinational firms has already become a Presidential campaign issue, the campaign tends to ignore vital facts about foreign investment and multinational taxation. This seminar seeks to fill this void.

The cost of the seminar is $250 per registrant; interested parties should call the Tax Foundation by September 5. For a room reservation at the Vista the night of the 12th, call 1-800-847-8232 by August 23.

The proceedings of the seminar will be provided to all attendees.

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TAX FOUNDATION'S VOL. 32, NO. 6 SEPTEMBER 1988

# TAX·FEATURES

## Bill Archer to Receive Distinguished Public Service Award at TF Annual Conference

Bill Archer, Republican Congressman of Houston, Texas, will receive the Tax Foundation's 1988 Distinguished Public Service Award at the Foundation's annual conference and dinner on November 30 in New York City.

Hans W. Wanders, Vice Chairman of the Board of The Wachovia Corporation and Chairman of the Board of Trustees of the Tax Foundation, will present the award to Congressman Archer. A major policy addresss by the congressman will follow his acceptance.

Congressman Archer is the ranking Republican on the House Ways and Means Committee and the ranking House Republican on the Joint Committee on Taxation. Elected to the Congress from the seventh district in Texas in 1971, Bill Archer has served consecutive terms since that time, gaining each reelection with a higher winning percentage than any other Republican congressman.

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**Hidden Taxes**

**Mark Your Calendars**
**To Attend**
**Tax Foundation's**
**Annual Conference**
**on November 30, 1988**
**in New York City**

## *"Soak the Rich" by Taxing the Highest Earners 100 Percent . . . And Run the Federal Government for 12 Days!*

One of the continuing hopes of income redistributionists is that high income taxes on top earners could generate significant amounts of revenue, enough to close the budget deficit gap without resorting to other politically painful choices. Tax Foundation's ongoing research into tax collections at various income brackets continues to show this is not a viable case.

At the very top—those with a million dollars or more in annual income—there simply are not enough taxpayers in this group to make a significant difference. If the redistributionists are serious about shutting down the deficit, they would have to reach far down the income scale, a move that would undoubtedly raise stiff political opposition. Higher tax rates for just the top five percent of taxpayers, for example, would mean tax increases on returns starting at $67,000 (including joint returns), a level of income which certainly does not qualify as "fat cat" status.

One way to illustrate the point is to take the most extreme example of confiscating all taxable income of top earners. While taxing any category of earners at a 100 percent rate would have a drastic effect on work incentives, and no one of any stature has actually proposed this, it can serve as a relevant object lesson.

### Starting with the Most Successful

Starting at the top, examination of 1986 individual income tax data (latest available) shows that those with adjusted gross income (AGI) of $1 million or over numbered 35,875 and represented just 0.03 percent of all taxpayers. Their adjusted gross incomes totaled $82.3 billion, their taxable

*(Continued on page 2)*

(SOAK THE RICH, *from page 1*)

income $66.3 billion, and they paid $33.7 billion in income tax with an average effective tax rate of 41 percent on AGI. If the Federal government simply confiscated all this group's taxable income, Uncle Sam theoretically would have netted $32.6 billion in additional revenue—enough to run the government for 12 days at 1986 outlay levels. Had that revenue been applied against the deficit that year, it would have made only a small dent.

## Reaching Down the Income Scale

Reaching deeper into the top brackets by confiscating 100 percent of taxable income from the $500,000-and-over group of 92,621, the Federal government could theoretically have extracted an additional $53.7 billion, sufficient revenue to pay its bills for 19.8 days or pay off about a quarter of the year's total deficit.

Taking it a step further, commandeering 100 percent of taxable income of the $200,000 and above earners hypothetically could have netted $88.4 billion from almost 400,000 taxpayers, enough to run the government a whole month. While this tactic is now generating some real money, it is also moving down from the rich to those who are merely very well off.

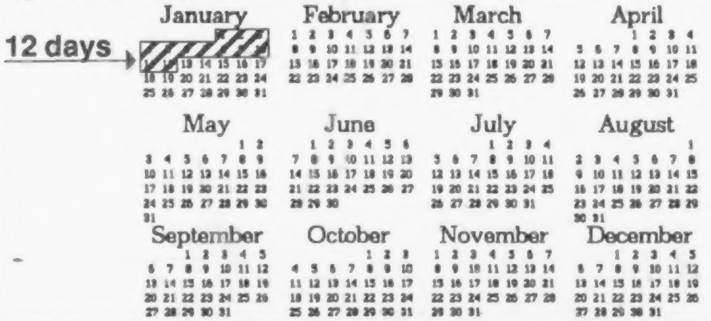
## Confiscatory Rates a Daunting Prospect

Statistically, it is a long way from $200,000 to the median 1986 family income of $29,458. Emotionally, it's a lot closer. Imagine the impact on middle-income workers who, contemplating a successful career, had to look forward to confiscatory tax rates as the price of success. Realistically, these rates could never approach 100 percent on any block of income (though the marginal rate did reach 94 percent during World War II). But if it were, say, 75 percent on all income above $200,000 with much lower rates applying below that, the impact on incentives of middle- and upper-middle income workers still could be shattering.

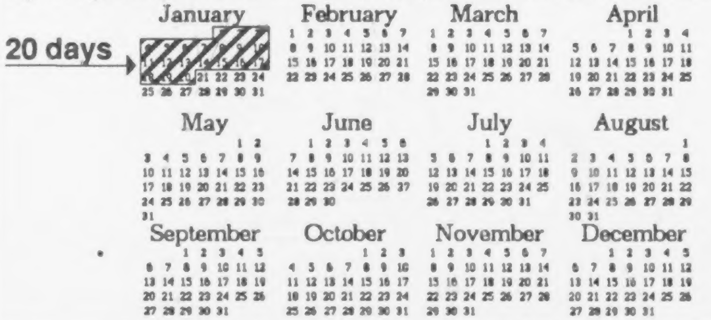
The accompanying tables provide further details.

### How Many Days Could the Federal Government Pay Its Bills By Simply Confiscating All the Taxable Income of Top Earners?

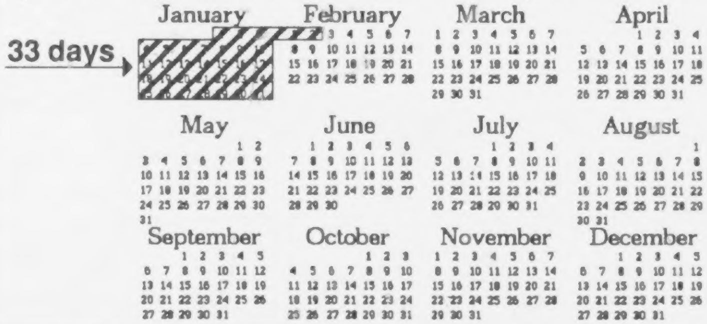
***By 100% taxation of those with $1 million or more:***



***By targeting those in the $500,000 or more bracket:***



***By reaching further, down to the $200,000 bracket:***



**So even with 100% taxation, a "soak the rich" policy will run the Federal government for only a few weeks.**

### Additional Revenues and Number of Days the Federal Government Could Run By Taxing Top-Income Brackets at 100%

Tax Year 1986

| Adjusted Gross Income Class | Number of Returns | Percent of All Returns | Adjusted Gross Income ($ Billions) | Taxable Income ($ Billions) | Income Tax Paid ($ Billions) | Average Tax | Effective Tax Rate (on AGI) | Net If Taxed at 100% ($ Billions) | Number of Days You Could Run Federal Government[a] |
|---|---|---|---|---|---|---|---|---|---|
| $ 1 Million or more | 35,875 | 0.03% | $ 82.3 | $ 66.3 | $ 33.7 | $ 939,202 | 41.0% | $ 32.6 | 12.0 Days |
| $ 500 Thousand or more | 92,621 | 0.09% | $ 119.4 | $ 96.8 | $ 43.1 | $ 465,588 | 36.1% | $ 53.7 | 19.8 Days |
| $ 200 Thousand or more | 398,769 | 0.39% | $ 206.6 | $ 165.2 | $ 76.8 | $ 192,635 | 37.2% | $ 88.4 | 32.6 Days |

[a] 1986 total Federal outlays equaled $ 989.8 billion or $ 2.712 billion per day.

Source: Tax Foundation computations based on Statistics of Income, Internal Revenue Service, U.S. Department of the Treasury.

Budget Watch By Allen Schick

# Will There Be a New Boom in Federal Spending?

As the Reagan presidency draws to a close, politicians and interest groups are preparing ambitious spending agendas for the next decade. The "in box" of ideas for new and expanded programs is fuller than at any time since Ronald Reagan took office in 1981. Despite the fact that the current Congress is not likely to act on most of these proposals, legislative activity is high as Members seek to build momentum for their favorite ideas. The first part of this article identifies some of the major items that might find their way into post-Reagan budgets; the second part discusses how the government might respond to emerging demand while it still faces high budget deficits.

## The Emerging Budget Agenda

For the first time in many years, the phrase "pent-up demand" has crept into budgetary debate. The phrase tells us something about the waning budgetary influence of a lame duck President, but it also indicates that the country may be on the brink of a new expansion in Federal programs. Public opinion polls show substantial support, higher than at any time in the 1980s, for maintaining or expanding the Federal government's support of education, health care, and other functions. Cutbacks are hardly talked about these days, a far cry from the situation just eight years ago when candidate Reagan was promising to downsize the Federal government.

> *For the first time in many years, the phrase "pent-up demand" has crept into budgetary debate. The phrase tells us . . . . that the country may be on the brink of a new expansion in Federal programs.*

The menu of ideas for new or expanded programs is unusually varied. Estimates of the cost of the various proposals are difficult to obtain, but the total is certain to run into the tens of billions of dollars. The following is a partial list of proposed initiatives.

> *Cutbacks are hardly talked about these days, a far cry from the situation just eight years ago when candidate Reagan was promising to downsize the Federal government.*

- **The savings and loan and bank crises.** The Federal government insures deposits of savings and loan institutions (S&Ls) and banks. The crisis in the savings and loan industry has received a great deal of attention, but there are growing indications that the banking sector may also be in trouble. The estimated deficit facing the Federal Savings and Loan Insurance Corp. (FSLIC) ranges to $60 billion or higher. The bigger the shortfall turns out to be, the greater the likelihood that FSLIC will have to turn to the Treasury for direct financial aid. Commercial banking insurance is provided through the Federal Deposit Insurance Corporation (FDIC), but though it began this year with about $18 billion in reserves, these may be depleted by a few costly bailouts.
- **Day care.** Both of the presidential candidates have endorsed major Federal support of day care. Their price tags are similar, about $2.5 billion each, but the approaches differ. The Democratic version would provide direct grants, the Republicans generally favor tax credits. Inasmuch as $2.5 billion would cover only a small portion of the families which might want day care, the final cost might be significantly higher.
- **National defense.** The amount of new resources provided to the Pentagon has not kept up with inflation in some recent years. Several factors may make it difficult or risky to continue this downtrend. The arms limitation agreement signed by Reagan and Gorbachev, negotiations for a broader strategic arms limitation, and possible curtailment of the strategic defense initiative (SDI) might portend a shift from strategic to conventional forces. But because conventional forces may be even more costly to acquire and maintain, the United States might have to decide between spending more on defense and shrinking its military capabilities.
- **Drug control.** Congress is convinced that money is the way to uproot this evil and it is moving to spend billions of dollars to eradicate illegal drugs. The issue has become so emotional and politicized, that it is hard to get serious debate as to whether providing vast amounts of money is the best way to deal with this problem.
- **Welfare reform.** The House and Senate have passed different versions, and they may not reach a compromise in the last days of the 100th Congress.

> *Both presidential candidates have endorsed major Federal support of day care. Their price tags are similar, about $2.5 billion each, but . . . inasmuch as $2.5 billion would cover only a small portion of the families . . . the cost might be significantly higher.*

(Continued on page 4)

(BUDGET WATCH, *from page 3*)

Depending on the election and other factors, next year's legislation might be even more costly than this year's.

■ **Medical care for the elderly.** Earlier this year, Congress passed and President Reagan signed into law a major expansion of Medicare's protection against catastrophic illness. This could be the forerunner of legislation to subsidize the care of chronically ill in their own homes or in nursing facilities. The cost of changes in Medicare has been underestimated habitually in the past, and it should not be surprising if further expansion turns out to be much more expensive than its advocates concede.

■ **Housing programs.** Because subsidized housing has been sharply cut back in the 1980s, demands to rebuild the housing stock and to assist low-income families are escalating. To make matters worse, a substantial portion of the assisted-housing built in previous decades might be taken out of the low-income market in coming years as the contracts under which they were financed expire. It would cost billions of dollars to keep this housing available for low-income people.

This list of demands on the budget is far from complete. It does not include proposals for new Federal assistance for education and job training, nor does it include any initiatives to protect the environment or to rebuild the nation's physical infrastructure.

> *. . . it will be exceedingly difficult to meet next year's deficit target under the Gramm-Rudman-Hollings law.*
>
> *Politicians, however, have ways of spending money without violating the deficit target.*

**Paying the Bills**

Not all of these ideas will make it into law, but some probably will. If some are adopted, they will encounter a tight budget that has no room for program expansions. The latest budget projections indicate that even without new spending, it will be exceedingly difficult to meet next year's deficit target under the Gramm-Rudman-Hollings law.

Politicians, however, have ways of spending money without violating the deficit target. Here are some of the tricks they might pull out of the bag.

■ **Mandates.** They can shift the cost of programs to businesses or other governments by requiring them to provide services which the Federal government is unwilling to pay for. A number of bills have been introduced in Congress to require employers to provide health insurance to all workers. The cost of expanded health coverage would not appear in the Federal budget and it would not, therefore, add to spending or the deficit. The fact that it would add significantly to the cost of doing business would be someone else's problem.

> *They can shift the cost of programs to businesses or other governments by requiring them to provide services which the Federal government is unwilling to pay for.*

■ **Tax credits.** The 1986 Tax Reform Act reduced tax rates by terminating or narrowing numerous preferences. But Congress might reverse course and enact new preferences as a means of financing some initiatives. Tax credits have been proposed for child care, education, medical care of the elderly, and other programs. There is a danger that the resurgence of credits might generate pressure to raise tax rates.

■ **Budget tricks.** Just because the Federal government spends money does not mean that the outlay appears in the budget. Spending can be excluded by taking the program or agency off budget, by issuing guarantees in lieu of direct spending, or by establishing special corporations to handle the transactions. All of these devices have been proposed as means of dealing with the crisis in the savings and loan and banking industries. Some have already been applied in the farm credit sector.

> *Spending can be excluded by taking the program or agency off budget, by issuing guarantees in lieu of direct spending, or by establishing special corporations to handle the transactions.*

■ **Change the deficit target.** Because the deficit target might be out of reach next year, there is a high probability that it will be revised by Congress. In the course of postponing the promise of a balanced budget a few years, Congress might be tempted to make room in the target for some additional spending.

■ **Raise taxes or enhance revenues.** If all else doesn't suffice, there is always a tax increase to pay the piper. Because raising taxes is not popular, politicians might throw in some "sweeteners" in the form of additional spending to mobilize public support.

The Reagan years have been exciting times for budget makers and watchers. The budget is likely to be just as exciting in the next decade, but the results might be different.

**Tax Features**

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FEDERAL TAX POLICY MEMO

**Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy**

**SEPTEMBER 1988**

# Hidden Taxes and User Fees: The Plague Spreads

**By John Hanly Adams**
**Editorial Consultant**

A jingle for the 1990s could be: A rose by any other name would smell as sweet; taxes by any other name can make you weep.

American taxpayers will need a lot of crying towels to get through the next decade. Both political parties are determined not to admit they will raise taxes. But up on Capitol Hill, where the tax-raising decisions are made, platoons of creative staff experts work away to devise new methods of raising revenue under any name except "taxes."

## Medicare "Premiums"

Latest example of this growing trend: The financing of expansion in the coverage of Medicare, the medical insurance system for people 65 and over. If you accept Social Security retirement benefits when eligible, as virtually everyone does, you are required to pay the premiums charged for Medicare even if you waive Medicare benefits, The Medicare premiums are deducted automatically from monthly benefit checks.

Starting January 1, 1989, the basic premiums go up about $4 a month per person, and Medicare enrollees will also pay an additional amount called a "supplemental premium." But it will be paid as part of their income tax, at the rate of $22.50 per every $150 of income tax liability in 1989. That used to be called a surtax.

Individuals at the bottom of the income scale escape the new surcharge if their tax liability is less than $1,000 in a given year. Around the taxable income level of $25,000 the surtax begins to be substantial, rising to a limit of $800 (that would be $1,600 for a married couple on Medicare) in 1989, at around $52,000 of taxable income. The "premium" goes up to $1,050 tops ($2,100 per married couple) by 1993. Beginning in 1994 the surtax is to be indexed to the annual rise in the program's costs.

Using the federal income tax to calculate and collect a special levy for a special purpose from a special group of taxpayers (those over 65 in this case) is termed "earmarking." It is a technique that will be increasingly used by Congress, unless there is a voter outcry, because often the tax boost can be hidden behind the name of a program. Thus a tax increase on parents, to finance child care, could be called an "education premium." National health insurance for everyone, seriously discussed lately, could be financed with "premiums" à la the Medicare model. Possibilities seem endless.

## Hits on Business

Less obvious than the new Medicare premiums for individuals—but potentially far costlier for taxpayers in general—are complicated changes in laws and regulations that force employers to pay, in one way or another, for various benefits to employees.

Tax laws passed in 1982, '83, '85 and '86 all had provisions that expanded employers' liabilities in connection with Medicare coverage of their retirees, for example. Those costs are not taxes technically, but they have the bite of taxes on a company's payroll costs and profits.

The shift toward "mandated benefits" as a substitute for federally-paid benefits, which would have to be financed by taxes eventually, is just in its infancy. It began with health and retirement benefits for full-time employees and now seems likely to be expanded into more extensive, and expensive, areas including child care and parental leave. One proposal would require employers to provide health insurance for part-time workers and their dependents, and laid-off workers.

Also proliferating are "rifle shot" tax increases aimed at selected businesses and hidden in a sense, within language so obscure only experts can figure it out and they often disagree. Provisions like that in the Revenue Act of 1987 affecting the tax status of insurance company reserves for life insurance liabilities are little noted except by those companies directly involved, but they pass the increases on as an addition to costs which everyone pays. "Rifle shots" are a favorite of Capitol Hill revenue shooters.

## User Fees

Another fertile field for "revenue enhancers" (versus plain old tax increases) are the charges levied by federal agencies for services and facilities they once provided as part of their mission.

This has become a favorite revenue lode for the Reagan administration, which "believes that direct beneficiaries should pay for services rather than all the taxpayers" as it was stated in the President's budget message for fiscal year 1989.

That philosophy actually flowered long ago, but it was not until 1952 that Congress got around to enshrining the concept of "user fees" in a statute, the Independent Offices Appropriation Act of 1952, Public Law 82-137. In recent years, as deficits and revenue demands soared, Washington has sharply boosted familiar fees, such as those at national parks, and imposed new charges on travellers, boaters, banks, shippers, importers and others. Only a few turfs with powerful political protectors in both parties—such as western public lands grazing fees and the

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VA loan guaranty fee—have been protected, for the most part, from higher charges.

No one seems to have a complete listing of federal user fees, largely because collecting agencies use differing definitions and report the revenue in different ways. The overall take is assumed to be large and rising, however, estimated at more than $3.3 billion in fiscal year 1987 for direct fees, licenses, tolls and the like.

A much larger amount, estimated at $14 billion in 1987, is collected in prices charged users for products including electric power, rents, facilities and services such as air traffic control. These prices are marked up periodically, with only the users and some congressional committees aware of the increases. Typically there is no other source of supply, or competitor, so customers have no recourse except to scream to Congress.

### "Quacks Like a Tax"

A growing argument in Washington: When does a user fee become a tax?

The latest flareup came over proposals to finance a revival of the U.S. uranium industry by buying $750 million worth of uranium for the federal stockpile and cleaning up toxic mine tailings with a trust fund established through fees paid by electric utilities and mining companies.

Treasury spokesmen said the fees more nearly resemble user fees than taxes. That was disputed by Representative Ronnie G. Flippo, Democrat of Alabama and a member of the tax-writing House Ways and Means Committee. At a committee hearing he was quoted by *Tax Notes* as saying "It sure looks like a tax, walks like a tax, quacks like a tax. While user fee is a nice term to look at conceptually, it has the same economic impact as a tax." It's an argument you'll be hearing again and again in the 1990s.

To insulate itself from that irritation, Congress sometimes pulls out of an activity, turning it over to a semi-private entity with minimal governmental connections. The U.S. Postal Service is the largest example. Postal rate increases, once hotly and loudly debated in Congress as crypto-tax hikes, now go through a rate-making process shielded to a great extent from public attention. Groups with big financial stakes in postal charges—publishers, direct mail advertisers, nonprofit organizations getting subsidized rates, postal workers unions—participate fiercely in rate debates. The general public just pays the bill. The 1988 jump in postal rates, boosting first class mail from 22 cents for the first ounce to 25 cents, will add $3 billion to the present $33 billion annual postal bill, which is double the bill of 10 years ago.

The very latest twist in user fees is to charge the public for advice and forms that must be used in meeting federal rules. Examples: New IRS fees for handling private rulings on tax questions, including computations for individuals' retirement annuities; determinations on tax-exemption requests; and the tax status of employee benefit plans.

## Taxing Regulations

The Internal Revenue Service has wide latitude in interpreting the Tax Code. By tightening its procedures, hiring more auditors, carrying more disputes to the courts, the IRS can squeeze more dollars out of taxpayers whether tax rates go up or not. This part of the revenue drive is getting a big assist from the gradual computerization of tax and transaction records, enabling the IRS to ferret out more income and tax it according to its interpretation of the increasingly complex statutes that Congress churns out virtually every year.

This general area is called "improving compliance" and is applauded by many who feel it is only fair that all taxpayers bear the burdens established by laws from Congress. But as those laws burgeon, in number and complexity, the gray areas where reasonable people differ about the laws' terms and the intent of Congress are widening.

The IRS itself cannot keep up with the law and its own regulations. The General Accounting Office, a congressional oversight agency, found IRS phone assistors answering only 61 percent of taxpayer questions accurately in a recent check. The IRS said its survey showed that 75 percent were correct. So 25 to 39 out of every 100 taxpayers asking guidance got bum dope and will pay penalties plus interest on any deficiencies the IRS eventually assesses. Incidentally, the IRS pays nine percent (currently) on any delayed refunds it owes you, but charges you 10 percent on penalties and deficiencies. That feels like a tax increase, to those who get stung.

## And Plans for More

On the horizon are many proposals that would have to be financed by taxpayers in some way. Any tax hikes, however, most likely will be slipped through the back door, wearing a mask. The "baseline smoke and mirrors" approach, first applied to the budget process to confuse and deflect the political backlash from deficit spending, now is being transferred as an operations gambit to tax policy—a development dismaying to long-time experts on taxes. Many tax initiatives are conceived in secrecy, drafted into legislation without public hearings, passed with little or no debate, and then buried in lengthy, complex legislation on other topics such as trade rules and massive appropriations bills.

Some nontax-tax ideas now circulating in Washington:

- Senator Edward M. Kennedy and others propose "Lifecare" to provide comprehensive medical care for children, the disabled and the aged, at home or in institutions. The estimated first-year costs: $20.5 billion, to be raised by eliminating the $45,000 cap on income subject to the Medicare payroll tax, plus added premiums for Medicare enrollees. The word "tax" would not have to be mentioned in the enabling legislation.
- Taxing the "imputed value" of various fringe benefits, such as health insurance, has been a Hill target for years and still is.
- Restricting further the issuance of tax-exempt bonds by states and localities, and renewed pressure to narrow or end tax exemption for the income from such bonds, at higher income levels, appeals to revenue hunters.
- Indexing federal excise taxes on gasoline and other products, so they could rise automatically (without much public notice, in typical circumstances) also is being floated.

In short: Get out the crying towels. No help is in sight, as yet.

## Social Welfare Outlays Dominate Government Expenditures

Governments in the United States paid out $727.9 billion for social welfare programs in fiscal year 1985 (latest officially reported) — showing a hefty $56.9 billion increase over the previous year. Social welfare spending accounted for nearly 52 percent of all Federal, state, and local expenditures climbing 8.5 percent over 1984 and amounting to 20.3 percent of GNP, according to economists at the Tax Foundation.

The $727.9 billion spent would be enough to give every man, woman, and child in the U.S. $3,049. The 8.5 percent increase in social welfare outlays reported for 1985 was modest when compared to spending increases in the recent past. During the 1960s, social welfare spending rose at an annual rate of nearly 11 percent; during the 1970s the rate jumped to almost 13 percent annually. Since 1980, annual growth has averaged just over eight percent.

Public welfare programs as defined by the Social Security Administration (SSA) include social security and public employee retirement, Medicare, Medicaid and cash payments under public assistance, unemployment compensation benefits, health, veterans' services, housing, education, and others.

### Emerging Federal Role

The source of social welfare financing has gradually shifted from state and local governments to the Federal government. In 1960, the Federal government's share was 48 percent, less than the state/local contribution; but by 1985, Federal social welfare expenditures of $451.1 billion represented 62 percent of the total.

### OASDHI—The Costliest And Still Growing

The largest and most expensive social welfare program, Old Age, Survivors, Disability, and Hospital Insurance (OASDHI), has grown more rapidly than any other. OASDHI payments of $260.5 billion in 1985 were seven times their 1970 size and now claim more than a third (35.8%) of all social welfare outlays, according to Tax Foundation economists. Federal budget figures for 1989 estimate that OASDHI expenditures will reach $317.8 billion — 22 percent higher than in 1985, the latest year covered in the SSA tabulations.

OASDI, the social security portion of OASDHI, has consumed an ever-increasing share of social welfare funds. In 1985 more than 15 percent of the civilian population received monthly social security benefits.

*(Continued on page 6)*

## THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

### "Learning to Ask the Right Questions"

Candidates for public office inevitably try to put the best construction on things. Prophets of doom seldom win elections.

This year's national races are no exception. On the stump, candidates are dodging the tough issues, putting the most favorable interpretation possible on every statistic and achievement that comes within range, and forecasting the best of all outcomes if they are elected.

The Tax Foundation is not in the forecasting business. We are, however, in the business of calling a spade a spade, of keeping the focus on the central issues, and of making sure all players are using the same set of numbers. The following questions suggest themselves for consideration — hopefully before the election, but most assuredly once the smoke has cleared and those who have won the right to govern must actually begin to do so.

- **Where's the fat?** We submit — as we have repeatedly said for years now — that there is still plenty of fat to be cut from virtually every publicly funded program in the Federal budget, and that a number of programs ought to be evaluated for sunsetting or swapping out so that some of the new issues can be addressed with new programs.

- **Do deficits matter?** In the face of a generation of deficit growth, a new breed of economists would answer that question, "Deficits don't matter." They would compute the shortfall as a percentage of gross national product, or find some other formula to justify the continued profligacy of the national government. Statist solutions to societal problems—simply throwing more money at them—have proven they don't work. The man or woman in the street already knows that deficits matter. They learned the answer the old-fashioned way by handling family budgets, managing credit cards, and balancing personal checking accounts. Deficits do matter. It's time we reminded the politicians that they do.

- **What taxes shall we raise?** One senses a tacit agreement in Washington that next year we'll have to raise taxes. We will hear calls for tax hikes disguised as user fees, revenue enhancements, co-insurance payments, mandated benefits or any other sheep's clothing the tax raising wolves can lay their hands on. America has yet to ask the *real* question: What percentage of the wage-earner's paycheck is government going to siphon off? Until we answer that, we cannot address the budget deficit, spending priorities, or revenue sources.

There are other questions. But these are a good start toward a national fiscal agenda from which we might expect some concrete results. I hope somebody remembers to ask them after the November election.

(SOCIAL SPENDING, *from page 5*)

When a program affects such a large proportion of the population, even relatively small programmatic changes have a large fiscal impact. For example, in 1985 the 3.5 percent cost-of-living benefit increase resulted in an $11.4 billion increase in outlays. The cost of care under the similarly large Health Insurance (Medicare) program increased 15.5 percent in 1985. Together, the Social Security and Medicare programs accounted for 37 percent of the total increase in social welfare spending in 1985.

## Spending on Education a Distant Second

Until the 1970s the largest category of social welfare programs was public education. In 1976 education spending fell to second place, leaving OASDHI as the dominant social program. The $166.4 billion spent on education in 1985 represented 23 percent of all social welfare costs, down substantially from 35 percent in 1970. Education continues to be largely a state and local responsibility, while social insurance and veterans' benefits remain predominantly federally funded.

Additional details on social welfare spending, broken down by category, are provided in the accompanying table.

## Social Welfare Expenditures under Public Programs by Source of Funds and Type

### Selected Fiscal Years 1960-1985

| Item[a] | 1960 | 1970 | 1980 | 1985 |
|---|---|---|---|---|
| | | | **A. Amount ($Millions)** | |
| Total expenditures | $ 52,293 | $ 145,856 | $ 492,797 | $ 727,861 |
| Social insurance | 19,307 | 54,691 | 229,754 | 372,583 |
| OASDHI | 11,032 | 36,835 | 152,110 | 260,469 |
| Public employee retirement | 2,570 | 8,659 | 39,490 | 63,042 |
| Unemployment insurance | 2,830 | 3,820 | 18,326 | 18,344 |
| Workmen's compensation | 1,308 | 2,950 | 13,457 | 22,263 |
| Public aid | 4,101 | 16,488 | 71,799 | 95,965 |
| Public assistance | 4,042 | 14,434 | 44,888 | 66,080 |
| Health and medical programs | 4,464 | 9,907 | 27,919 | 39,955 |
| Veterans' programs | 5,479 | 9,078 | 21,466 | 27,171 |
| Education | 17,626 | 50,846 | 121,050 | 166,362 |
| Elementary and secondary | 15,109 | 38,632 | 87,150 | 120,742 |
| Higher | 2,191 | 9,907 | 26,176 | 35,445 |
| Vocational and adult | 298 | 2,144 | 7,375 | 9,891 |
| Housing | 177 | 701 | 7,210 | 11,879 |
| Other social welfare[b] | 1,139 | 4,145 | 13,599 | 13,947 |
| From Federal funds, total | 24,957 | 77,337 | 302,616 | 451,143 |
| Social insurance | 14,307 | 45,246 | 191,162 | 313,106 |
| Public aid | 2,117 | 9,649 | 48,667 | 61,174 |
| Health and medical programs | 1,737 | 4,775 | 12,688 | 18,403 |
| Veterans' programs | 5,367 | 8,952 | 21,254 | 26,833 |
| Education | 868 | 5,876 | 13,452 | 13,740 |
| Housing | 144 | 582 | 6,608 | 10,339 |
| Other social welfare[b] | 417 | 2,259 | 8,786 | 7,548 |
| From state and local funds, total[a] | 27,337 | 68,519 | 190,180 | 276,718 |
| Social insurance | 4,999 | 9,446 | 38,592 | 59,476 |
| Public aid | 1,984 | 6,839 | 23,133 | 34,792 |
| Health and medical programs | 2,727 | 5,132 | 15,231 | 21,552 |
| Veterans' programs | 112 | 127 | 212 | 338 |
| Education | 16,758 | 44,970 | 107,597 | 152,622 |
| Housing | 33 | 120 | 601 | 1,540 |
| Other social welfare[b] | 733 | 1,886 | 4,813 | 6,398 |
| | | | **B. Percentage Distribution** | |
| Total social welfare expenditures | 100.0% | 100.0% | 100.0% | 100.0% |
| Federal | 47.7 | 53.0 | 61.4 | 62.0 |
| State-local | 52.3 | 47.0 | 38.6 | 38.0 |
| Exhibit: Total as a percent of GNP | 10.3 | 14.7 | 18.5 | 20.3 |

[a] Subtotals include items not shown seperately. Total financed from state and local funds includes minor amounts for veterans and housing programs.

[b] Includes institutional care, child nutrition and welfare, vocational rehabilitation, and other social welfare programs not elsewhere classified.

Source: Social Security Administration, Office of Research and Statistics; and Tax Foundation computations.

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